# NOTES

## Taft-Hartley—Separation of Function in N. L. R. B.

On June 23, 1947, the Senate enacted the Taft-Hartley Act[1] into law over the vigorous veto of President Truman who objected to the Act on the ground, *inter alia,* that it was "unworkable."[2] One of the many features of the new act which has been the subject of much controversy was the change it worked in the organization and procedure of the National Labor Relations Board, the administrative machine charged with enforcing the national labor policy in this field. The principal organizational theme of the Act in relation to the N. L. R. B. was its so-called "separation of function," *i.e.,* the separation of prosecuting and investigating unfair labor practice charges from their adjudication, the former functions being assigned to an independent prosecutor's office while the latter was retained by a National Labor Relations Board, enlarged from three to five members.[3]

The recent resignation of General Counsel Robert Denham at the "request" of President Truman[4] highlights the bitter disputes which have been raging for several years over the feasibility of such a functional separation and focuses our attention to a reexamination of the scheme involved here. It is the purpose of this Note to explore its advantages and disadvantages in the light of its three years in actual operation, and to suggest possible legislative changes. First, however, a brief review of the prevailing conditions under Taft-Hartley's predecessor is in order.

### Twelve Years Under the Wagner Act

The Wagner Act marked the entrance of our federal government into a highly complex field of social and economic relations with little previous experience or understanding of the innumerable problems to be encountered. The mandate of this Act was broad and general—to implement collective bargaining and work out techniques and methods of preserving labor's rights to freedom of industrial association. It is suggested that this monumental task could only have been successfully undertaken by an administrative agency with the highest degree of flexibility to explore, investigate, analyze and fashion the most applicable remedies to the many novel unfolding situations.

In its twelve year operation under the mandate of the Wagner Act,[5] The Board had been committed to no single, rigid system of organization

1. Labor Management Relations Act of 1947, 61 Stat. 136, 29 U.S.C. §§ 141-197 (Supp. 1947).
2. See the text of the veto message in 93 Cong. Rec. 7485 (1947).
3. LMRA § 3(a).
4. N.Y. Times, Sep. 16, 1950, p. 1, col. 2.
5. 49 Stat. 449, (1935), 29 U.S.C. § 151 (1940).

throughout its various branches. It had, in fact, undertaken several internal reorganizations and revised its rules of practice and procedure.[6] Gradually, its internal organization became stabilized and for several years prior to the enactment of Taft-Hartley there was an internal separation of function whereby within its regional offices the personnel engaged in investigating and prosecuting were generally separated from those conducting elections and performing other work.[7] Hearing officers were assigned from Washington and upon conclusion of hearings, records were transferred to the Washington office for a sort of appellate procedure where arguments to the Trial Examiner's preliminary findings were received. At this Washington level, the record might be examined by the Review Section, [abolished in Taft-Hartley, § 4(a)] which advised the Board and drafted summaries of the pertinent sections of the record. As to the initiation of action by the issuance of unfair labor practice complaints, the Regional Directors possessed a substantial amount of autonomy, but they reported regularly on these affairs to the Secretary in Washington who in turn kept the Board informed. This provided the Board with a desirable flexibility in that it could advise with regional officers regarding new situations and it was also in a position to manage the calendar of cases coming before them so as to best work out the policies to be announced. The ability to pick the order of cases to be decided was regarded as an important instrument of uniform policy-making.[8] The practices of the Board followed meticulously the requirements of the Administrative Procedure Act [9] which will be discussed later.

The above practices were very similar to those adopted by the bulk of administrative agencies under federal sponsorship. Experience had apparently proven this pattern to be efficient and manageable from the agencies points of view.

However, twelve years of vigorous N. L. R. B. activity under the Wagner Act impressed many of the Taft-Hartley sponsors with the conviction that this agency was adjudicating with an unduly partisan (prolabor) attitude.[10] Moreover, the agency had not won wholehearted public approval of its activity.[11]

The prevalence of this attitude by Congress and large segments of the public was probably the inevitable consequence of the Board's creation to administer an Act establishing new rights for labor and no affirmative rights for its adversary. Inasmuch as only employers could be "prosecuted"

6. See MILLIS AND BROWN, FROM THE WAGNER ACT TO TAFT HARTLEY, chap. 2 (1950).

7. See *Hearings Before Committee on Labor and Public Welfare on S. 55 and S.J. Res. 22*, 80th Cong., 1st Sess., 1898 (1947).

8. *Op. cit. supra* note 6 at 39, 43.

9. 60 STAT. 237, 5 U.S.C. § 1001 *et seq.* (Supp. 1946).

10. See HARTLEY, OUR NEW NATIONAL LABOR POLICY 141, 142 (1948); N.L.R.B., LEGISLATIVE HISTORY OF THE LABOR MANAGEMENT RELATIONS ACT OF 1947, 296, 297, 316, 613, 883 (1948).

11. Note the testimony of former Board member Gerard Reilly in *Hearings Before Committee on Labor and Public Welfare on S. 55 and S.J. Res. 22*, 80th Cong., 1st Sess., 2045 (1947).

under the Act, it seems only natural that agency personnel should have worked very closely with the representatives of organized labor. Moreover, the general reluctance of management to accept the Wagner Act without a fight undoubtedly served to engender a certain *esprit de corps* among the personnel and members of the Board.[12] Thus, it is not surprising that many Congressmen who were genuinely alarmed at the growing power of large labor organizations acted to effect a change in the economic and political *attitude* of the agency. To effectuate this desire, the procedural scheme of the N. L. R. B. under the Wagner Act had to be revised to accommodate the new policies mirrored by Taft-Hartley.

## Functional Separation Under Taft-Hartley

This Act, unlike the Wagner Act, comprehends no vigorous program to implement the rights of a single economic group; it envisions rather the striking of a delicate balance weighing evenly the interests of the two competing groups. Many Congressmen believed that a judicial attitude was infinitely more desirable than the often singular purpose outlook of the former agency. Therefore, the original House Bill contemplated the complete dissolution of the N. L. R. B. and establishment of a new labor court with all the administrative functions of investigating, prosecuting, and conducting elections vested in a single administrator.[13] This proposal was modified to the present system by the Conference Committee which may have felt that modification was necessary in order to win support against an almost certain veto.

The basic provisions of the final compromise are to be found in § 3(d) which transfers from the Board to a General Counsel *final* authority respecting the investigation and prosecution of unfair labor practice charges under § 8 and supervisory power over attorneys and other personnel in the Regional Offices. On the other hand, the Board retained power to conduct certification proceedings (representation elections), and to *appoint* attorneys, Trial Examiners, and "such other employees as it may from time to time find necessary." In addition, the Board was to serve strictly as the adjudicating branch in unfair labor practice cases and was to conduct the so-called "union-shop" elections under § 8(a)(3). Congressman Hartley, author of the original proposal was quick to venture his opinion that the compromise effectively retained all the significant features of his plan.[14] However, with representation proceedings conducted under the exclusive direction of the Board, it is doubtful if Mr. Hartley's statement is really accurate.

## Functional Separation . . . An Evaluation

*The Advantages.*—Traditionally the enforcement activities of administrative agencies are instituted on the agency's own motion upon receipt

12. *Ibid.*
13. See H.R. 3020, 80th Cong., 1st Sess. (1947).
14. Hartley, Our New National Labor Policy 79 (1948).

of a complaint from parties feeling aggrieved by some invasion of their rights. This was the usual pattern under the old N. L. R. B. The agency, however, was deemed to be in complete charge of its own proceedings and might refuse to take action at all if it thought this best in the particular case. In most cases, its refusal to act was not deemed judicially reviewable, perhaps because it had promulgated no order running against anyone with standing to appeal.[15] Thus, by refusing to institute any action for enforcing the law, an administrative agency might be in a position to render a specific law practically ineffective. The hazard of permitting an agency to deny relief by inaction is particularly strong where the agency may be wholly unsympathetic with the basic policies of the statute it alone can enforce.

One arrangement to mitigate against the danger of administrative inaction would be to permit the parties to initiate their own actions in the courts as Taft-Hartley does in the case of contract breaches and secondary boycotts.[16] This, however, is extremely undesirable in the labor-management field for overburdened courts are unable to deal expeditiously with the delicate economic problems that must be handled rapidly and efficiently if the disastrous effects of industrial strife are to be avoided. Moreover, there is a need in this field for the expertness and specialized experience which only exists in a body of experts who can at once assess and weigh the interests of public, employer and worker. Therefore, the separation of function envisaged by Taft-Hartley may be seen as an attempt to combine the *expertness* and speedy action of the administrative agency with the vigorous enforcement characteristic of the independent public prosecutor.

Under Taft-Hartley, administrative inaction is still clearly possible, for the General Counsel may in his absolute discretion refuse to prosecute a given complaint. The difference between enforcement by an independent prosecutor and a combined function agency is that under the former arrangement responsibility for prosecution is isolated in a single, independent office where inaction may be more easily detected and treated. Further, a prosecutor can build a reputation only through the vigor and efficiency of his enforcement program, whereas, in the fused-function agency, prosecution may be subordinated to other activities through many influences that would not act on one whose sole job is prosecution. A particular hazard of the old scheme was that a regional officer might reasonably hesitate to initiate action which he did not feel assured would meet favorably with the Board members to whom he was responsible. The penalty for too much independence in this case would be loss of employment, assignment to undesirable work or forfeiture of opportunities for promotion. This danger is not so strong where he is responsible to an independent prosecutor.

15. Jacobsen v. N.L.R.B., 120 F.2d 96 (3d Cir. 1941); See generally Note, *Statutory Standing to Review Administrative Action*, 98 U. of Pa. L. Rev. 70 (1949). See also Amalgamated Utility Workers v. Consolidated Edison Co., 309 U.S. 261 (1940).

16. LMRA §§ 301, 303.

It has been suggested that one of the major vices of most administrative agencies is their tendency to become eventually over-identified with the group regulated, particularly after dealing with the group for a period of many years.[17] Contacts formed may tend to convince the agency personnel that the regulated group is not such a bad lot after all, and friendships acquired with members of the group may tend to destroy much of the zeal and fire with which the agency once began its task. Here too, the existence of an alert and independent prosecutor, whose success depends on the scope and success of the prosecutions he undertakes, may mitigate against the hazard of administrative inaction. For somewhat similar reasons, private persons are occasionally permitted to initiate criminal actions in cases involving gambling, liquor violations, prostitution and other activities inimical to the public interest when there is great temptation for inaction by the public force.[18]

*The Disadvantages*—The business of the National Labor Relations Board falls roughly into two classes: it supervises the representation proceeding which establishes a bargaining unit and certified representative and also ultimately decides the unfair labor practice charges which are investigated and prosecuted by the General Counsel. In the latter case, compliance with the Board's determination may have to be enforced by the courts where the General Counsel is necessarily the Board's agent in defending the ruling. The failure of the Act to define and interrelate more clearly the duties of each branch has been responsible for some measure of confusion and regrettable dispute between the Board and the General Counsel. They have failed to see eye to eye in defining their respective roles under the separation of function. For example, one provision of the new Act provides that in the event of a strike only those workers then employed plus those entitled to re-instatement shall be eligible to vote in any representation election currently conducted.[19] Thus, unfair labor practice strikers are entitled to vote while "economic" strikers who have been permanently replaced are not entitled to vote. In a recent case,[20] the General Counsel dismissed unfair labor practice charges asserted by strikers. They were, therefore, categorized as "economic" strikers and denied the right to vote in an ensuing election. The Board somewhat reluctantly felt itself bound by the General Counsel's determination, and therefore, it could not make an independent investigation to determine the status of the strikers.

A more serious problem might arise where strikers have asserted charges of company domination against a rival union only to have them dismissed by the General Counsel for lack of evidence or other factors. In determining whether to accord the accused union a place on the ballot, the Board might very well feel that its responsibility for a fair election entitled

17. See Davis, *Administrative Powers*, 63 HARV. L. REV. 192, 221-222 (1949).
18. See Jaffe, *The Individual Right to Initiate Administrative Process*, 25 IOWA L. REV. 485, 505-506 (1940).
19. LMRA §9(c)(3).
20. Times Square Stores Corp., 79 N.L.R.B. 361 (1948).

it to hold hearings of its own and inquire into this issue. Such action might easily be justified on the ground that the usual remedy for company domination in an unfair labor practice case (*i.e.*, an order of disestablishment) need not be issued here and that the only effect of a Board decision on this issue would be to exclude the union from the ballot in certification proceedings. As for the practical effect on the accused union, the distinction would prove extremely tenuous. Apparently this problem has not yet arisen but remains as an embarrassing possibility.

In any event, a General Counsel angered by any such Board decision is in a position to stymie it if the employer refuses to bargain with the certified union. This is due to the fact that the only effective way in which the Board's certification can be enforced is through the charge of refusing to bargain with the certified union.[21] This charge is one of unfair labor practice where the General Counsel's discretion to dismiss is final.[22] Thus, the prosecutor is in a position to nullify almost any action the Board might take in a certification proceeding.

Still another situation in which the present system may be weak is where an employer and a labor union each seek to file charges accusing the other of an unfair labor practice with regard to the same occurrence or event. Inasmuch as the General Counsel represents the complainant in these proceedings, he might face a difficult choice in deciding which party he will serve as advocate, although presumably he could also prosecute both parties in the same hearing.

In addition to the friction occasioned by the disagreements between the Board and the General Counsel as to their respective functions, serious differences of fundamental policy have arisen. The dispute between General Counsel Denham and the Board members on the question of jurisdiction, once a lively source of friction,[23] seems to have been finally settled with the Board's decision that it will dismiss any complaint in cases involving less than a minimum amount of interstate commerce.[24] The Board's position was that the "policies of the act" would best be promoted by refusing to entertain jurisdiction in cases where the interstate commerce is "insubstantial." They may well have had a weather eye to the serious backlog of cases awaiting their determination, but Mr. Denham (then General Counsel) had vigorously contended that once he had entertained a complaint, the Board could not dismiss on policy grounds if technical jurisdiction did in fact exist. The Board overruled this contention in *Smith, d. b. a. A-1 Photo Service*,[25] and the new General Counsel has apparently accepted this determination as binding on him.[26] While the opinion of the Board is entitled to much weight in these matters, it seems difficult to find

21. *Cf.*, Baltimore Transit Co., 59 N.L.R.B., 159 (1944).
22. LMRA § 3(d).
23. See N.Y. Times, Oct. 6, 1950, p. 18, col. 6.
24. *Ibid.*
25. 83 N.L.R.B. 564 (1949).
26. N.Y. Times, *supra* note 23.

in the legislative history of Taft-Hartley any ground for the decision. Indeed, the backers of Taft-Hartley may have felt that the "little fellow" was the one who might well most need the protection of the Act.[27]

Another possible area of disagreement arose in the Board's decision that only local unions asserting charges or seeking certification need comply with the Taft-Hartley requirements concerning non-Communist affidavits.[28] The General Counsel had vigorously argued that the locals were not entitled to use the machinery of the N. L. R. B. unless their international officers had also filed the affidavits. Had the General Counsel chosen not to honor the Board decision here, we might have seen the locals being certified by the Board but unable to force an employer to bargain with them because the General Counsel had decided they were not entitled to the benefits of the Act.[29]

In another case, both the Board and the General Counsel had sought an injunction in the courts against a union which challenged the action on the ground that the Board could not delegate to the General Counsel the function of seeking preliminary injunctions. Mr. Denham took the position that he had this power irrespective of any delegation by the Board. The Board, however, wanted him to argue that it had the power but could delegate it. Only after the Board threatened to file a separate brief was it able to persuade Mr. Denham to present both arguments in the alternative without revealing the disagreement. The court accepted the Board interpretation.[30] The case highlights the possible weakness in forcing the Board to rely on a disagreeing General Counsel to defend its rulings in the courts. It may be said that this is no worse than the situation wherein a district attorney may be forced to defend a court's ruling on a different theory than that which he favors. The analogy is far from perfect, however. A district attorney's success or failure in the handling of an appeal will seldom have the far reaching economic effect that will often arise in a labor-management case. Because the Board felt that the effect of its decision on national labor policy was extremely important, it recently filed a separate brief asking the court to ignore the arguments of the General Counsel's brief.[31] Perhaps, the Board should be permitted to appoint a solicitor to represent it on appeal.

In mitigation of these several hazards it may be pointed out that the power of presidential removal operates as a powerful lever in securing the necessary cooperation between both branches of the agency. President Truman's action in "forcing" the resignation of General Counsel Denham is a case directly in point. It also shows, however, the possibilities available to a President openly hostile to the Taft-Hartley Act. Some suggestion

27. It is difficult to believe that Congress intended the benefits of the act only for the corporate giant.
28. Northern Virginia Broadcasters, 75 N.L.R.B., 11 (1947).
29. The courts apparently will have a chance to interpret the provisions of the act relating to the Communist affidavits. See West Texas Utilities Co. v. N.L.R.B., 184 F.2d 233 (D.C. Cir. 1950).
30. See Evans v. Int'l. Typographical Union, 76 F. Supp. 881 (D.C. Ind. 1948).
31. See N.Y. Times, Sep. 16, 1950, p. 10, col. 2.

has been made that the Act gives the President no power to remove the General Counsel,[32] in view of the Congressional emphasis on an *independent* prosecutor and the fact that Taft-Hartley expressly provides for removal of Board members [33] but remains silent as to the General Counsel.

*Evaluation.*—That these differences in opinion between General Counsel and Board have resulted in some inconvenience and uncertainty is undeniable. But initial differences of scope and interpretation are to be expected under bifurcation just as one might expect differences in opinion between district attorney and judge or between the Commissioner of Internal Revenue and Tax Court. They detract from perfectly uniform administration but the occasional friction developed does serve to insure that all issues are brought into the open for examination and consideration by the public as well as the courts and Congress. In fact, one defect of the standard administrative agency may well be that not all these differences reach the attention of the public and Congress so that corrections can be made.

Contrary to general expectations, this separation of function has not resulted in any seriously increased cost of agency operation. The old N. L. R. B. had already achieved a large measure of internal separation with officers engaging in prosecution very rarely involved in other work.[34] The new arrangement may be viewed more as a division of power rather than a doubling of personnel. The Regional offices continue to handle most of the work involved in both unfair labor practice and representation proceedings. Trial Examiners are still sent from Washington and the record continues to go to the Board in Washington for consideration and decision.

The extreme functional separation envisaged by Taft-Hartley may be justly criticized if it results in any appreciable failure to encourage the speedy, informal settlement of these delicate disputes between large unions and large employers. The ability of the standard administrative agency to negotiate these informal settlements has been aptly described as the very life blood of the administrative process.[35] The old Board had pointed with considerable pride to its record in this department.[36] Opponents of bifurcation point with alarm to the relatively low percentage of informal settlements in Pennsylvania and Wisconsin where separation has been adopted in the state labor machinery.[37] This was the principal objection which the Attorney General's Committee raised to any functional division.[38] Though it may be true that a prosecutor might be less inclined to encourage private agreement than the usual administrator, three years of operation under Taft-Hartley have seen no serious increase in the proportion of cases pro-

32. *Ibid.*
33. LMRA § 3(a).
34. *Supra* note 7.
35. See REP. OF ATT'Y. GEN. COMM. AD. PROC. 58, 59 (1941).
36. See *Hearings, supra* note 7 at 1928.
37. *Ibid.*
38. *Op. cit. supra* note 35 at 58.

ceeding to formal litigation, except in the area of the new substantive provisions. It seems only natural to expect more litigation while the law is being initially explored and tested than one would expect at a later stage. As a matter of fact, this seems to have been the case with the old N. L. R. B., whose record in this respect shows a marked increase in private settlements during later years of its operation. The problem here seems largely one of good statesmanship and an enlightened prosecutor might just as well be inclined to avoid unnecessary litigation as would be an agency which is both prosecutor and judge.[39] Moreover, the existence of a vigorous prosecutor might conceivably serve to deter many violations where the uncertainty of standard administrative action might not. Significantly, the bulk of agency work is still processed through the regional level where the staffs are highly experienced in the technique of negotiating these important informal and speedy private settlements.

Apparently no data has been published showing the average speed with which cases are disposed of under the new system when they proceed to formal hearing and decision. The Hoover committee, however, did report that the office of the General Counsel has handled its work very smoothly while a considerable backlog of cases has piled up on the Board.[40] This is somewhat inconclusive since the lag in the Board's work is probably caused by its additional responsibility of conducting union shop elections under Taft-Hartley.[41]

It is at once obvious that separation of function is feasible only in a limited number of agencies, *i.e.*, in those whose operations involve primarily the prosecution of charges on which a clear cut adjudication can be made. In the unfair labor practice charge we see the most ideal setting for this scheme of organization. The advantages of more vigorous prosecution and centralized responsibility flowing from the functional separation are partially offset by the necessity for enforcing certification orders through the medium of an unfair labor practice charge (refusal to bargain). This provides the General Counsel with an avenue either to nullify or greatly hamper the Board's action. Therefore, an examination of possible legislative correction is desirable.

## Proposed Alternatives

The suggestion has been made that interlocutory judicial review of representation proceedings would be desirable.[42] Under such a procedure, the issues at stake in a representation proceeding could be effectively settled and would become res judicata before the General Counsel is called upon to enforce the decision in a complaint charging the parties with a refusal to bargain with the certified representatives. This alternative is undesirable,

39. See Benjamin, Administrative Adjudication in the State of New York 52 (1942).

40. As reported in 11 N.A.M. Law Digest 53 (1949).

41. As provided in LMRA § 8(a)(3).

42. *Hearings, supra* note 7 at 1930.

however, in that it would almost invariably serve as a weapon of delay and seriously increase the workload of the agency staff. It would require the Board to supervise a separate staff of attorneys specializing in these appeals. The present backlog of cases awaiting the Board's time and consideration is already serious and increased pressure would possibly prove disastrous.[43]

At the time Taft-Hartley was being considered by Congress the argument was advanced by many that the newly passed Administrative Procedure Act[44] would serve to protect the parties against the alleged bias of the N. L. R. B.[45] and therefore the whole scheme of functional separation was unnecessary. No exhaustive analysis of this Act is contemplated here, but it is desirable to note the difference in emphasis between the Administrative Procedure Act (APA) and Taft-Hartley.

The APA grew out of the recommendations of the Attorney General's Committee on Administrative Procedure. The majority of this committee had expresslly rejected the idea of functional separation for prosecuting agencies.[46] The minority of the committee, nevertheless, had approved it for a limited number of agencies.[47]

Section 5(c) of the APA meets the separation of function problem with the requirement that:

> ". . . No officer, employee, or agent engaged in the performance of investigative or prosecuting functions for any agency in any case shall, in that or a factually related case, participate or advise in the decision, recommended decision or agency review . . . except as a witness or counsel in public proceedings. . . ."

It will be noted that the emphasis of this Act is on separation of function at and during the *hearing* and *decision* levels. The whole tenor of the Act is to secure a *fair hearing* for those affected by agency action, while the Taft-Hartley functional separation is directed toward seeing that action is instituted in the first instance. Obviously if the agency officers file no complaint or institute no action which will call for a hearing, the Administrative Procedure Act will not apply at all. Since this method is the precise manner in which an agency unsympathetic to a given statute can render it ineffective, the Taft-Hartley emphasis on the initiation of action by an independent prosecutor may be seen as complementary to the APA rather than in conflict with it.

Another proposed remedy seems more designed to meet the defects of the present duality in agency function. This is the suggestion that since the most bitterly assailed feature of Taft-Hartley bifurcation lies in the

43. *Supra* note 40.

44. 60 STAT. 237, 5 U.S.C. § 1001 *et seq.* (Supp. 1946).

45. See *Hearings, supra* note 7 at 1050.

46. REP. ATT'Y. GEN. COMM. AD. PROC. 55-60 (1941).

47. *Id.* at 208.

General Counsel's unlimited discretion to dismiss complaints, he should be required in such cases to file a written opinion. This would have a salutary effect in that it would (1) caution the General Counsel against purely arbitrary action, (2) require him to give a reason for his dismissal, and (3) would inform the parties and the public when the dismissal is based on his disagreement with a Board decision in certification proceedings. A fourth advantage stemming from such a requirement would be that a body of precedent would be established on which future legislative changes could be predicated.

It should be noted that the number of instances where the General Counsel has dismissed a complaint are extremely few and presumably arise largely from a lack of evidence on which to pursue the charges rather than a desire to stymie Board decisions with which he is in disagreement. In any event the requirement of a written statement explaining the dismissal would indicate clearly the basis of such action and might possibly open the way to the use of *mandamus* where he is acting capriciously or under a clear error of law.

*Conclusion.*—A reasonable conclusion appears to be that the independent prosecutor system should afford public gains in the vigor of an enforcement program. But if the system should lead to a genuine *impasse* between the two branches of the agency, potential vigorous enforcement might not be worth its price. It would seem, however, that careful tailoring and good statesmanship may be relied on to avoid the possibility of stalemate so that functional separation may become both feasible and desirable. It should be noted that Board Chairman, Mr. Paul Herzog, himself a vigorous opponent of separation, recently admitted that, some efficiency has come of this system.[48] In addition, the Congressional Committee appointed to supervise the functioning has reported that it is working well.[49] Perhaps we shall find that its greatest benefit stems from the increased public confidence and respect that the Board may earn by its removal to a judicial capacity.

*James R. Ryan*

## Manipulation of the Stock Markets Under the Securities Laws

Manipulation of the stock markets was one of the principal motivating forces behind the enactment of the Securities Exchange Act of 1934. The Congressional statement of policy condemned manipulation as having adverse effects upon the fluctuation of the volume of bank credit, upon the appraisal of security values for purposes of taxation, and upon the valuation of collateral for bank loans and the operation of the national banking

48. As reported in 11 N.A.M. LAW DIGEST 52 (1949).
49. *Ibid.*

system generally.[1] While these indictments were probably true, the real impetus of the legislation was apparently the fostering of free and open security markets, without artificial, fictitious alteration of demand or supply.

Understanding of this fundamental objective requires the comprehension of the economic functions and justifications of stock markets. During the infancy of the corporate form of business association, it was assumed that dissolution of the corporation, as in the case of a partnership, would secure to the owners the repayment of their investment.[2] But one of the principal advantages of the corporate form, *i.e.*, its durability despite change in the identity of the associates, led to a state of affairs where dissolution was only to be expected of unsuccessful ventures. Thus the investor in capital stock had no means of recovering his investment from the corporation, and sale of his shares to a third party became the practice by necessity.[3] The primary function of stock markets is to supply the necessary element of liquidity to corporate investment and secondarily to direct the necessary private capital into industrial investment.[4] Liquidity of security holdings provided by the stock markets enhances their value to the prospective investor and thus is an indirect aid to corporate expansion. It is obvious that in the case of debt securities, the investor will ultimately recover his principal investment from the corporation, assuming its continuing solvency, but the added liquidity to his investment provided by the security markets will still be an important factor in enhancing its value.

Since the principal economic justification of security markets is the liquidity they supply to corporate security investment, the ideal market is therefore one where the forces of supply and demand are allowed to operate unfettered by artificial stimulation or depression.[5] The investigation by the Senate Committee on Banking and Currency prior to the enactment of the Securities Exchange Act exposed the pronounced failure of the organized security exchanges to perform their true economic function.[6] The existence of manipulative practices on the exchanges was politely ignored by exchange officials provided there were no technically fictitious transactions such as wash sales or matched orders, and reports of manipulative activity were dismissed as unfounded rumors.[7] That this attitude was wholly unjustified was established by the evidence gathered by the investigating committee.[8] Manipulation of security prices not only hampers

1. SECURITIES EXCHANGE ACT OF 1934 § 2(3), 15 U.S.C. § 78b(3) (1946) (hereinafter cited as EXCHANGE ACT § 2(3)).

2. Berle, *Liability for Stock Market Manipulation*, 31 COL. L. REV. 264, 265 (1931).

3. *Ibid.*

4. INVESTMENT BANKERS ASSOCIATION OF AMERICA, FUNDAMENTALS OF INVESTMENT BANKING 353 (1947).

5. STOCK EXCHANGE PRACTICES, *Report of the Senate Committee on Banking and Currency pursuant to S. Res. 56, 84, and 97*, SEN. REP. No. 1455, 73d Cong., 2d Sess. 30 (1934) (hereinafter cited as REPORT).

6. *Ibid.*

7. *Ibid.;* DICE AND EITEMAN, THE STOCK MARKET 300 (1941).

8. *Op. cit. supra* note 5.

the true functioning of a security market in supplying a genuine index of the liquidity of an investment,[9] but the artificial changing of this index clearly operates as a species of fraud upon all those who change their position in reliance upon the manipulated prices or upon the manipulated volume of trading.[10]

The scope of this study includes primarily an investigation of those practices which result in an artificial stimulation of demand or supply for a security, whether entered into for an unlawful motive or not, such as wash sales, matched orders, pool activities, and stabilization, and secondarily, an inquiry into transactions which do not have a manipulative effect per se but which are susceptible of abuse in the hands of manipulators, being particularly adapted to their needs. It is not intended to consider what constitutes fraud in general under the securities laws, nor the obligations of disclosure of material facts except as the existence of manipulative activity may be involved. Similarly, no consideration will be given to the problem of "insider" trading in securities except so far as actual manipulation of prices by such insiders may have occurred.

## Common and Statutory Law of Manipulation Prior to the Securities Exchange Act

Lawfully recognized injuries occasioned by manipulation are two-fold: (1) An injury to the state through the tampering with the free and open market; (2) Injuries to private individuals who change their positions in reliance upon the manipulated market. The operative facts, however, which create the respective liabilities are usually the same with the exception that in actions by private individuals an element of damage must be shown. With these basic premises in mind a review of the law of manipulation in England and in the United States prior to the national securities legislation is appropriate.

*England.*—The first case in the English courts involving manipulation was *Rex v. DeBerenger,*[11] wherein two defendants circulated false rumors that Napoleon had been killed and that peace would soon be proclaimed. They were convicted for a conspiracy to raise the price of Government securities by means of the false representations with intent to injure the public, the court observing that the state had a right that the national market should not be tampered with. It was intimated obiter that a combination to effect a large number of transactions for the sole purpose of raising or depressing the price level would also be indictable, without the circularization of any false rumors. The concept of a free and open public market was further expanded in *Regina v. Aspinall,*[12] wherein a prosecution for

9. Twentieth Century Fund, The Security Markets 687 (1935).

10. United States v. Brown, 5 F. Supp. 81 (S.D.N.Y. 1933), *aff'd,* 79 F.2d 321 (2d Cir. 1935), *cert. den.* 296 U.S. 650 (1935)

11. 3 M. & S. 67, 105 Eng. Rep. 536 (K.B. 1814).

12. 1 Q.B.D. 730 (1876), *aff'd,* 2 Q.B.D. 48 (1876).

obtaining registration of a security on the London Stock Exchange through false representations was successful, non constat the lack of any intent to defraud the public. And the dictum of the *DeBerenger* case was fortified by the decision in *Scott v. Brown*,[13] wherein recovery on a contract to form a pool for the creation of fictitious trading in a security, in order to induce subsequent purchasers to believe that the stock had a bona fide market, was denied on the ground that the participants to the contract were *in pari delicto*. The effect of this case was mitigated however by a subsequent decision which indicated that where the syndicate was formed for the purpose of "pegging" the price of a security to facilitate a distribution, and the pegged price was "fair", the syndicate did not constitute an illegal conspiracy.[14]

Civil recovery by purchasers of securities affected by manipulative or fraudulent acts has been more circumscribed. Though recovery was granted in the case of a security which had been listed on the London stock exchange by means of the false representations of the defendant, upon a subsequent price decline,[15] the doctrine of reliance in the law of deceit proved an effective brake to extension of this holding. Thus, where the directors issued a prospectus containing false representations, but the plaintiff was not one of the original subscribers to the stock and therefore did not see the prospectus nor in fact rely directly on the false statements, recovery was denied on the ground that the representations were not addressed to him.[16] Similarly, the mere presence of false representations in a prospectus proved insufficient to grant recovery to a plaintiff who sold short and was then caught in a corner of the market, because of the absence of reliance.[17] It was added in the latter case that there was no private right to a market free from manipulation.

Thus the English cases, while recognizing the right of the state to a free and open market, became enmeshed in the traps of reliance and privity when civil cases were involved.[18] The concept that fictitious, manipulative transactions were a species of fraud and were actionable without proof of reliance or privity of representation was yet to develop.

*Common law in the United States.*—No reported cases have been discovered recognizing the right of the state to the preservation of free and open security markets without the aid of a statute. However, recovery on a contract entered into to raise the price of securities by means of fictitious transactions has been denied on the ground that the parties were *in pari*

13. 2 Q.B.D. 724 (1892).

14. Sanderson v. British Westralian Mines and Share Corp., 43 Sol. J. 45 (1898), *aff'd sub nom.* Sanderson v. British Mercantile Marine & Share Co., reprinted in U.S. v. Brown, 5 F. Supp. 81, 90 (S.D.N.Y. 1934).

15. Bedford v. Bagshaw, 4 H. & N. 538, 157 Eng. Rep. 951 (1859).

16. Peek v. Gurney, L.R. 6 H.L. 377 (1873).

17. Salaman v. Warner, 64 L.T.R.N.S. 598 (Q.B.D. 1891), *aff'd*, 65 L.T.R.N.S. 132, 7 T.L.R. 484 (Ct. App. 1891).

18. Moore and Wiseman, *Market Manipulation and the Exchange Act*, 2 U. of Chi. L. Rev. 46, 65 (1934).

*delicto*,[19] even before the English case of *Scott v. Brown*[20] was decided. Similarly, contracts for the dissemination of purportedly unbiased information about the merits of securities in which manipulators were interested,[21] and for the "stabilization" of the price of a security by the directors of the issuer,[22] were declared illegal for this purpose, though in the latter case a dissent contended that stabilization was a lawful activity as it operates only to support the market, as contrasted with the creation of a fictitious market by manipulation.

The only reported civil case in point was a suit by a purchaser of a security against a manipulator who created fictitiously high prices by the operation of wash sales, involving no change of beneficial ownership.[23] Recovery was denied despite proof of the subsequent decline in the value of the stock, on the ground that wash sales were at most false affirmations of an *opinion* as to value. This reasoning is patently incorrect and ignores the fact that a wash sale is a false representation that a bona fide sale between arms' length buyer and seller took place at the quoted price.

*State Statutes.*—The pioneer state in the enactment of penal laws regulating manipulation, as might be expected, was New York, since it was the security trading center of the country. The making of false and misleading statements concerning securities, and the reporting of fictitious transactions therein, were prohibited.[24] Apparently the more widely used remedy, however, was the so-called Martin Act,[25] which permitted the fraudulent sale of securities to be enjoined by the Attorney-General of New York City. Under this statute manipulative activity such as the creation of a false appearance of active trading by means of wash sales,[26] and the circularization of information recommending the purchase of securities in which the publisher was financially interested,[27] was prohibited. Criminal statutes in other states which might be construed as applicable to manipulative activity are mostly limited to the prohibition of false and misleading advertising.[28] It can be readily supposed that the quotation of prices on the exchange which do not represent bona fide sales might be held to be false advertising, but to the writer's knowledge no reported case has presented this problem.

19. Livermore v. Bushnell, 5 Hun 285 (N.Y. 1875).

20. See note 13 *supra*.

21. Ridgely v. Keene, 134 App. Div. 647, 119 N.Y. Supp. 451 (1909).

22. Harper v. Crenshaw, 82 F.2d 845 (D.C. Cir. 1936), *cert. denied*, 298 U.S. 685 (1936).

23. McGlynn v. Seymour, 14 Daly 520 (N.Y.C.P. 1888).

24. N.Y. Penal Code §§ 951, 952; People v. Farson, 244 N.Y. 413, 155 N.E. 724 (1927).

25. N.Y. Gen. Business Law § 23a.

26. People v. Rice, 221 App. Div. 443, 223 N.Y. Supp. 566 (1927).

27. People v. Brady's Financial Service, 236 N.Y. Supp. 864 (App. Div. 2d Dept. 1929, *mem. opinion*).

28. See Moore and Wiseman, *Market Manipulation and the Exchange Act*, 2 U. of Chi. L. Rev. 46, 65 (1934).

*Federal Mail-Fraud Statute.*—The federal statute prohibiting use of the mails in the furtherance of fraudulent schemes [29] formed the jurisdictional basis for the leading case in the United States involving manipulation of security prices prior to the federal securities legislation. In *United States v. Brown,* the defendants were convicted for forming a pool to manipulate the market in a certain stock, effecting wash sales, and "touting" the stock being manipulated by means of fraudulent circulars. Over the objection that the operations of the pool did not constitute a fraud (presumably on the ground that the fictitious sales were merely false affirmations as to value) the court held that outsiders reading the stock market quotations are justified in supposing that the quoted prices are appraisals of value due to a series of *actual* sales between persons dealing at arms' length in a free exchange market, and if instead the quotations represent *fictitious* sales, a fraudulent scheme for the purpose of this statute is established, despite the lack of any proven damage to the purchasers.[30]

The results of the mail-fraud cases [31] are of course limited by actual holding to criminal punishment under the enabling statute. Nevertheless, the language used in the opinions was so broad as to justify Professor Berle's conclusions that the consummation of a sale in the exchange market, as it is reported, is equivalent to a representation of a bona fide arms' length transaction, and is a material representation because the price of such a sale becomes an element in every subsequent offer to buy or sell.[32] Further, he contends that artificial manipulative transactions are essentially a form of fraud which constitutes a sufficient basis for civil liability to a defrauded purchaser, or criminal liability by way of an injunction or permanent punishment under appropriate statutes.[33]

Though the fundamental bases of liability had been previously formulated by the courts, it remained to the Securities Exchange Act of 1934 to specify and define manipulative practices and to provide effective means of investigation and enforcement.[34] Regulations under that Act may be conveniently divided into two categories: activities unconditionally prohibited, and activities lawful unless contrary to rules and regulations of the Securities and Exchange Commission. The former category includes wash sales and matched orders, creation of a false and misleading appearance of activity for the purpose of inducing purchases by others, dissemination of information designed to induce the purchase or sale of securities, and the making of false and/or misleading statements. The latter includes stabiliza-

29. 18 U.S.C. § 338 (1946). Under this statute, the Post Office Dept. announced a policy of not hesitating to issue fraud orders against every person engaged in the use of the mails for the carrying of "tipster sheets" or "market services." Information Service, Post Office Dept., 7/17/33.

30. See note 10 *supra.*

31. In addition to United States v. Brown, *supra* note 10, see Harris v. United States, 48 F.2d 771 (9th Cir. 1931).

32. Berle, *Liability for Stock Market Manipulation,* 31 Col. L. Rev. 264, 270 (1931).

33. Berle, *Stock Market Manipulation,* 38 Col. L. Rev. 393, 397 (1938).

34. *Id.* at 393.

tion, short sales and stop-loss orders, puts, calls, and other options, and "manipulative or deceptive devices or contrivances." In addition the fraud provisions of the Securities Act of 1933 are frequently invoked in the regulation of manipulative practices.

The organization of the material to follow is in line with the distinction between activities absolutely prohibited and activities lawful unless contrary to rules and regulations. The latter category has been further divided, however. One more or less clearly defined area includes activities innocuous *per se,* but which have been employed as aids to manipulation, *e.g.,* puts, calls, and other options, and short sales and stop-loss orders, to which has been added the power to define "manipulative or deceptive devices or contrivances"; the other area is stabilization, which is in essence a form of manipulation but which has so many beneficial aspects that it was not considered justifiable by Congress to prohibit it altogether without thorough study of the problem by an expert Commission.

## Activities Absolutely Prohibited

*Wash Sales and Matched Orders.*—The view that wash sales and matched orders constituted only false affirmations of an opinion as to value[35] had been expressly rejected by the time of the passage of the Securities Exchange Act, and it was recognized that the fictitious nature of these transactions in creating a deceptive appearance of active trading was a material misrepresentation.[36] The statute made unlawful the effecting of any wash sale or sale upon matched orders for the purpose of creating a false or misleading appearance of active trading in any registered security.[37] While it is conceivable that a wash sale might be effected for other reasons, in the majority of cases the only rational inference is the prohibited purpose.

As a practical matter wash sales and matched orders seldom occur by themselves but rather as parts of a larger scheme of manipulation.[38] Use of these crude devices in this manner has been discovered by the Commission as recently as 1946;[39] however the more subtle attempts usually shun these devices in favor of the placing of sell and purchase orders with a large number of brokers who have no actual knowledge of the existence of correlative orders to purchase or sell.[40] These activities will be discussed under the heading "Pool Operations," *infra.*

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35. McGlynn v. Seymour, 14 Daly 520 (N.Y.C.P. 1888).

36. People v. Rice, *supra* note 26.

37. Exchange Act § 9(a) 1, *House of Representatives Committee on Banking and Currency,* H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934).

38. *E.g.,* United States v. Brown, *supra* note 10; Matter of Charles C. Wright, 3 S.E.C. 190 (1938), *aff'd sub nom.* Wright v. S.E.C., 112 F.2d 89 (2d Cir. 1940); Matter of Michael J. Meehan, 1 S.E.C. 238 (1935); R.J. Koeppe & Co. v. S.E.C., 95 F.2d 550 (7th Cir. 1938).

39 Matter of W.S. Wien & Co., Exch. Act Rel. No. 3855 (9/17/46).

40. *House of Representatives Committee on Interstate and Foreign Commerce,* H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934).

*Dissemination of False and Misleading Information.*—It has been previously noted that the circularization of purportedly impartial recommendations of securities by those financially interested therein was deemed to be a fraudulent sale of securities in New York prior to the Securities Exchange Act.[41] The use of the mails for this practice gave jurisdictional grounds to the federal courts under the mail fraud statute to criminally punish manipulative activity.[42] It was established by both Congressional and private investigations that a common practice by pool operators was the employment of publicity agents or publishers of "market services" to tout the stock in which the pool was conducting manipulation.[43] A flagrant example was the publishing of the "Stock and Bond Reporter" by one David M. Lion, who netted over $500,000 profit on the options given him as compensation for publicizing securities in connection with 250 pool operations during 1928-30. He also employed one McMahon to boost the manipulated stock. The latter posed as an economist, broadcasting on the radio as the "McMahon Institute of Financial Research." A further example was the regular appearance of a column in the New York Daily News called "The Trader;" the writer being compensated out of pool profits.[44]

Under the Securities Exchange Act this nefarious practice was effectively prohibited by sections 9(a)3 and 9(a)5, which forbid the dissemination of information by any prospective seller or purchaser as to the likelihood of a rise or fall in the price of any registered security due to the market operations of others, or the dissemination of such information by any person receiving a consideration therefor from any prospective seller or purchaser. Only one reported case had actually resulted in an injunction or a criminal prosecution under these sections,[45] but the principal reason for this paucity of authority is the fact that such activity usually is part of a general scheme to manipulate prices of a security, which is prohibited by § 9(a)2.[46]

The Act also contains a general prohibition against the making of false and misleading statements as to any registered security,[47] analogous to § 17 of the Securities Act of 1933,[48] which was intended to prohibit the use of such statements in connection with manipulative operations. This section requires that the statement be "false or misleading with respect to

41. See notes 21 and 27 *supra.*

42. See note 31 *supra.*

43. *Senate Committee on Banking and Currency,* SEN. REP. No. 792, 73d Cong., 2d Sess. (1934); REPORT, at 36; *Hearings Before Senate Committee on Banking and Currency Pursuant to S. Res. 56, 84, and 97,* 73d Cong., 1st Sess. (1933), Cutten, at 5900 (hereinafter cited as *"Hearings"*); TWENTIETH CENTURY FUND, THE SECURITY MARKETS 466 (1935).

44. REPORT at 36 *et seq.*

45. R.J. Koeppe & Co. v. S.E.C., 95 F.2d 550 (7th Cir. 1938).

46. *Ibid.;* Matter of Michael J. Meehan, 1 S.E.C. 238 (1935); S.E.C. v. Torr, 15 F.Supp. 315 (S.D.N.Y. 1936), *rev'd,* 87 F.2d 446 (2d Cir. 1937).

47. EXCHANGE ACT § 9(a) 4.

48. 15 U.S.C. § 77a *et seq.* (1946), hereinafter cited as SECURITIES ACT.

any *material* fact." In the past, civil recovery in deceit for misrepresentations was often hampered by holdings that the statements involved were of "opinion," or "law," rather than of fact, and therefore the misrepresentation was not "material," [49] but the modern tendency seems to be to eliminate these technical distinctions.[50] It seems a fair assumption that this tendency would be continued in the interpretation of § 9(a)4. In the only reported civil case posited on this section, however, recovery by a purchaser against a dealer who represented that a certain stock would rise 15 points in the next few days was denied on the ground that the representation was a mere statement of opinion as to future happenings; there was no connection between the statement and the subsequent drop in price.[51] The court observed that the plaintiff "must have either entered a false market or paid a false price to enter a genuine market" because of the language of § 9(e), giving a civil right of action to those who purchase "at a price affected" by acts declared illegal by § 9.

*Manipulative Pool Operations.*—Manipulation has been defined as a "planned effort by an individual or a group of individuals to make the market price of a security behave in some manner in which it would not behave if left to adjust itself to uncontrolled or uninspired supply and demand." [52] It is noteworthy that this definition does not necessarily include any motive or expectancy of profit at the expense of the investing public and is therefore broad enough to include stabilization (discussed *infra*), which is usually conducted without any such purpose. Under this heading, however, it is proposed to discuss only manipulation entered into with the express purpose of deceiving others through the fictitious activity created.

The concept of a pool signifies a joint undertaking by a group of speculators to alter the price of a security artificially and profit by the movement in price so engineered.[53] Pools may intend to either raise or lower the price, being appropriately termed "bull" and "bear," respectively.[54] As early as 1912 Congressional investigations uncovered

49. *E.g.*, Industrial Trans. Co. v. Russell, 238 S.W. 1030 (Tex. Civ. App. 1922); Lone Star Life Ins. Co. v. Shield, 228 S.W. 196 (Tex. Civ. App. 1921) (stock would be worth 25% more than present price by a certain date, and purchaser would receive yearly 8% dividend); Upton v. Tribilcock, 91 U.S. 45 (1875) (non-assessability of stock).

50. *E.g.*, Browne v. San Gabriel River Rock Co., 22 Cal. App. 682, 136 Pac. 542 (1913); Loomis v. Pease, 234 Mass. 101, 125 N.E. 177 (1919); Haebler v. Crawford, 258 N.Y. 130, 129 N.E. 319 (1932).

51. Rosenberg v. Hano, 39 F. Supp. 714 (E.D. Pa. 1940), *aff'd*, 121 F.2d 818 (3d Cir. 1941).

52. Twentieth Century Fund, The Security Markets 444 (1935). The distinction between normal and manipulative conduct depends largely on mental attitude and purpose rather than any objective distinctions between the two types of conduct. Andresen, *Manipulation of the Over-the-Counter Securities Markets*, 10 Geo. Wash. L. Rev. 639, 641 (1942).

53. Report at 31.

54. Few examples of "bear raiding" were discovered. *Mathias, Manipulative Practices and the Securities Exchange Act*, 3 U. of Pitt. L. Rev. 7, 20 (1936).

some flagrant examples of pool operations, e. g. the pool in the stock of the Columbus and Hocking Valley Coal Co.[55] The pool manager in that case had 59 different accounts with a single brokerage firm, and orders to buy were scattered among 25 different brokers who were unaware of the common source of their employment. A price rise from 27 to 90 was so effected, and after the pool had liquidated its long position and sold short, the price dropped to about 30 in one day. The existence of operations of this kind as discovered in the investigations prior to the passage of the Securities Exchange Act was one of the principal reasons for the adoption of that legislation.[56]

The operation of a typical bull pool may be summarized as follows.[57] The manipulators select a stock to which popular attention has been directed or may easily be directed, for instance, by real or apparent prospects of a favorable merger, stock split, or favorable earnings statement. It is then necessary to assure themselves of a sufficient source of supply for the stock at prices lower than the expected price produced by the artificial activity. This may be done by selling short at prices on a scale down, accompanied by unfavorable rumors, which depressed the price, allowing the pool to cover and start their activity to raise the price. However the more common practice was to secure an option at a fixed price or graduated prices not far above the market from the issuer or its officers or directors. The use of an option allows the manipulators to enter the market at the least cost and risk. So-called "stand-off" agreements may be negotiated between the pool and the holders of large blocks of stock to be manipulated obligating the latter not to liquidate during the price rise to be created by the manipulators and so hamper the operation. If there are any stop-loss orders slightly below the market (the presence of which may be ascertained from the books of the specialist in the stock), it will pay the manipulators to sell short and depress the price to the level of the stop-loss orders, for execution of the latter will drive the price down and allow the manipulators to cover and acquire a source of supply at a very low figure. The next step is the stimulation of demand and the creation of a fictitious appearance of active trading. Market letters are sent out to brokers and dealers for the purpose of inducing investors to buy. Professional publicity agents are hired to tout the stock in newspaper columns and on radio programs, while posing as unbiased "economists" or market analysts. Concurrently, active trading among the members of the pool is initiated, though care was usually taken not to effect any technical wash sales or matched orders, which were prohibited by the rules of the exchange.[58] In order to induce speculators to enter the market

55. INVESTIGATION OF FINANCIAL AND MONETARY CONDITIONS IN THE UNITED STATES, 62d Cong., 2d Sess. (1912), Popper, at 904.

56. EXCHANGE ACT § 2(3); compare DICE AND EITEMAN, THE STOCK MARKET 300 (1941).

57. REPORT at 36 *et seq.;* DICE AND EITEMAN, *supra* n.56, at 310; Note, *Market Manipulation and the Securities Exchange Act,* 46 YALE L.J. 624 (1937).

58. TWENTIETH CENTURY FUND, *op. cit. supra* note 52 at 471.

and get a "free ride" (their transactions of course have as much market effect as those of the pool), the pool granted "puts" so that the speculators would be protected against loss in the event of failure of the operation. In many instances, brokers were authorized to effect actual wash sales. Through all of these devices, demand is artificially stimulated. When the price rises sufficiently, the pool exercises its options. Active buying and selling is continued with a preponderance of sales. As soon as the long position of the pool has been liquidated, short sales may be effected, while active trading is still going on among the pool. After the pool has sold short as much as the market will bear without breaking, pool support is withdrawn and a precipitous decline usually ensues, catching all the outsiders who lacked the knowledge or the foresight to unload before the break. The pool is then enabled to cover its short position at a low price, having profited both from the rise it created by purchasing and the inevitable decline by short sales.

It is patent that manipulative activities of this nature seriously impair the efficiency of a security market in performing its function of supplying liquidity to investment.[59] The frequency of such devices in the pre-1934 era was appalling. It was discovered that during 1929 alone 105 issues listed on the New York Stock Exchange were subject to one or more pools or syndicates managed by member firms; and during 1929-33, 175 member firms participated in pool profits.[60] It is more pleasant to report that after the passage of the Securities Exchange Act the pool dropped out of sight.[61] Probably this was due to a large extent to the fact that the exchanges are required to treat such conduct as grounds for expulsion.[62]

It would seem to require a fantastic stretch of the imagination to justify any activity of the sort just described. Yet such statements as the following have appeared in print:

> "The pool is little more than an organization on a scientific basis, of a 'group of insiders'. It is a group of men who are farsighted enough to see the potentiality of any stock and the logic of its eventually selling at the price and in the direction which the pool decides upon. All that the pool generally does, therefore, is to discount the future in a scientific way and hasten a market change which, without organized action, might take ten times as long to accomplish. Economically, the pool serves a worthy purpose of assisting the open market in evaluating correctly the true worth of a stock." [63]

This apology was substantially reiterated by the then president of the New York Stock Exchange, testifying before the Senate Investigating

59. *Id.* at 687.

60. REPORT at 32-33.

61. *Hearings before House Committee on Interstate Commerce on Proposed Amendments to the Securities Acts,* 77th Cong., 1st Sess. (1941), Purcell, at 62 (hereinafter cited as *"Hearings-Amendments"*).

62. *E.g.,* NEW YORK STOCK EXCHANGE CONSTITUTION, ART. XIV, § 7.

63. SCHABACKER, STOCK MARKET THEORY AND PRACTICE 570-571 (1930).

Committee in 1933.[64] The fallacy is no more forcefully indicated than by the fact that the inspired effect of the pool in assisting the open market to find the "correct" price for the stock usually terminates abruptly as soon as the manipulators have reaped their profit, and the subsequent decline nullifies all of their noble endeavor.

*Role of the Specialist.*—As intimated *supra,* the specialist in the manipulated stock is an invaluable ally of the pool.[65] A specialist in a particular stock is an exchange member who is responsible for the execution of all orders in the stock which cannot be immediately effected at the then market level. He keeps a record of all these orders in his books and by making them known to the pool, pertinent information about the sources and extent of the floating supply of a stock, and the existence of bids below and offerings above the market, may be obtained.[66] In one of the most profitable pools discovered by the Congressional investigation, the specialist was a member of the pool manager's firm, which fact speaks for itself, though at the hearings the specialist denied disclosing his books.[67] Under the Securities Exchange Act the disclosure of a specialist's books to pool operators is forbidden.[68] The New York Stock Exchange also prohibits such disclosure, and in addition the mere existence of an interest on the part of a specialist in a pool manipulating the stock in which he is the specialist is prohibited.[69]

The general lack of exchange supervision over pool operations was one of the causes of the extensive regulation enacted in the Securities Exchange Act.[70] The only exchange prohibition that would have been applicable was the ban on wash sales and matched orders,[71] but as has been noted, the pool was usually careful to avoid technical violation of these rules by placing orders with brokers who did not know of the existence of corresponding orders with other brokers. This type of artificial activity apparently did not conflict with either the rules or the ethics of the exchanges.[72]

*Manipulation Under the Securities Exchange Act.*—Section 9(a)2 of the Securities Exchange Act outlawed the effecting of a series of transactions in any registered security creating actual or apparent active trading therein, or raising or depressing the price thereof, for the purpose of in-

64. *Hearings,* Whitney, at 6616.

65. REPORT at 47; Mathias, *supra* note 54, at 29.

66. LOSS, CASES AND MATERIALS ON S.E.C. ASPECTS OF CORPORATE FINANCE 81 (1947).

67. *Op. cit. supra* note 65.

68. EXCHANGE ACT § 11(b) 2.

69. NEW YORK STOCK EXCHANGE, RULES OF THE BOARD OF GOVERNORS, Rules 362, 363.

70. REPORT at 30.

71. SENATE COMMITTEE ON BANKING AND CURRENCY, SEN. REP. No. 792, 73d Cong., 2d Sess. (1934).

72. REPORT at 31.

ducing the purchase or sale of such security by others. The constitutionality of this section has been sustained against attacks for vagueness and for interference with intrastate commerce.[73] The operative facts may be conveniently grouped as follows: 1) a series of *transactions,* 2) creation of actual or apparent active trading therein, or raising or depressing the price, and 3) intent to induce the purchase by others. It would seem that the requirements (1) and (2) of the offense are synonymous as a practical matter for any series of transactions, if effective on an exchange or on the over-the-counter market, will have the inevitable effect of creating active trading and/or raising or depressing the price.[74] And it is possible that a perfectly legitimate operation will be effected through a series of transactions having the requisite appearance and price consequences, e. g. the mere accumulation of a large block of stock, or its liquidation.[75] Therefore the real battleground is the *intent* with which these transactions were effected, and this subjective criterion is the distinguishing feature of unlawful manipulation.[76] Before examining the nature of manipulative intent, however, a preliminary problem is often presented as to what constitutes a transaction for this purpose.

(a) Transactions.—The original draft of the Congressional bills which ultimately became the Securities Exchange Act contained the language "series of purchases and sales . . . creating actual or apparent active trading . . .",[77] and as noted, the bill as enacted into law used the language "transactions." [78] This change evidenced Congressional recognition of the fact that transactions other than actual purchases or sales may have the same effect. This principle was recognized in *Matter of Kidder Peabody & Co.,*[79] wherein it was decided by the Commission that the mere placing of bids in the over-the-counter market was included within the term "transactions," though apparently there were purchases and sales on the exchange being simultaneously effected. This holding is almost a matter of necessity since the probative task of establishing actual sales in the over-the-counter market would be quite burdensome.

(b) Manipulative Intent.—Where the legal consequences of any act depend upon the intent with which it was done, a critical probative problem arises from the fact that direct evidence of intent is usually impossible to obtain outside of admissions thereof.[80] Therefore the well known rule that

73. Wright v. S.E.C., 112 F.2d 89 (2d Cir. 1940).

74. *Hearings-Amendments,* Geer, at 1359.

75. Opinion of General Counsel of Commission, Exch. Act Rel. No. 3056 (10/27/41); see United States v. Minuse, 114 F.2d 36 (2d Cir. 1940).

76. Andresen, *supra* note 52.

77. § 8(a) 3 of S. 2693 and H.R. 7852, 73d Cong., 2d Sess. (1934).

78. EXCHANGE ACT § 9(a) 2.

79. Exchange Act Rel. No. 3673 (4/3/45); *accord,* Matter of W.S. Wien & Co., Exch. Act Rel. No. 3855 (9/17/46); Matter of Halsey Stuart & Co., Exch. Act Rel. No. 4310 (9/23/49).

80. *Hearings-Amendments,* Purcell, at 69.

intent may be presumed from the acts done operates in the law of manipulation by necessity. Objective circumstances are the chief criteria used by the courts and the Commission in establishing manipulative intent and frequently are accorded greater probative value than testimony by the offenders of a "normal business purpose."

The normal inference from the execution of a series of transactions such as made up the old pool operation, i. e. unloading securities to the buying public immediately after accumulation of a large block for purposes of resale, even though no artificial activity was caused in the process, is that the operator's intent was to manipulate, and this is the position of the Commission.[81] However, the mere process of accumulating a large block of shares at prices within the normal past market range, without any subsequent sale to the public, was held to be insufficient to establish the requisite intent; [82] and the Commission has ruled that the lapse of a reasonable time after accumulation of a block of stock for resale, during which the market price has found its own "independent level," before public distribution takes place inferentially rebuts manipulative purpose.[83] But the mere presence of independent purchases of the security at a price level to which the stock had been raised by manipulation does not rebut intent, because presumably the manipulative transactions raising the price still have the effect of making purchasers pay more than they would have paid absent the manipulation.[84]

Even without any subsequent public distribution of the security accumulated by the series of transactions raising its price, there may be situations where the circumstances surrounding the transaction or the manner in which the manipulative transactions were effected indicate manipulative intent. Thus, where the brokers involved were financially interested in a new issue of securities to be publicly offered at a fixed price, their series of transactions pending effectiveness of the registration statement raising the price of outstanding securities of the same issuer prompted the Commission's observation that ". . . we find it very difficult to ascribe to that person any intent other than that prohibited." [85] Similarly, when the person accumulating a supply of a security "reached" for it, indicating a preference to pay a higher rather than a lower price, channeled requests to buy from him into the market so that the price of the transaction would be reported, and held a series of options at increasing prices, it was held that the manipulative purpose was established.[86] The same result was reached where the acts of the manipulators included, *inter alia,* the execu-

81. Opinion of General Counsel of Commission, *supra* note 75.

82. S.E.C. v. Bennett, 62 F.Supp. 609 (S.D.N.Y. 1945).

83. See note 81 *supra.*

84 Matter of Federal Corp., Exch. Act Rel. No. 3909 (1/30/47).

85. *Ibid.*

86. Matter of Charles C. Wright, 3 S.E.C. 190 (1938), *aff'd sub nom.* Wright v. S.E.C., 112 F.2d 89 (2d Cir. 1940).

tion of each day's closing transaction at a price above that of the previous day.[87]

In the presence of strong circumstantial evidence of manipulative intent as exemplified by the foregoing acts, direct testimony by the manipulators of alleged motivations such as the bona fide belief that the security should sell at a higher level,[88] or "making a market" for securities by stockholders to aid in the financing of the issuer [89] is usually disregarded, and justifiably so. Also, a showing of a specific intent to influence purchases on an exchange is not necessary since the sole requirement is that the manipulation be conducted in a registered security.[90] In addition, at least for the purposes of injunctive or other relief at the instance of the Commission, or of criminal sanctions, the presence of damage to any persons who were induced to purchase the security by the manipulated activity, is immaterial, though it is a prerequisite to civil recovery.[91]

(c) Manipulation in the Over-the-Counter Market.—Section 9(a)2 by its terms applies only to securities registered on a national securities exchange, as do the remainder of the prohibitions of § 9. Therefore if transactions which would violate § 9(a)2 are conducted in unregistered securities in the over-the-counter market, there is no express statutory prohibition involved. However, § 15(c)1 prohibits the effecting of any transaction, or the inducing of the purchase or sale of any security, by means of any "manipulative device", the Commission to define such device. It was held by both ruling and decision that conduct which would violate § 9(a)2 if effected in a registered security violates § 15(c)1, and also § 10(b), if effected in an unregistered security.[92] And as has been noted, the mere placing of bids, without any proof of actual purchases or sales, is sufficient to constitute a transaction for this purpose.[93]

*Industry Supervision of Manipulation.*—The provisions of the Constitution of the New York Stock Exchange which may be used to add expulsion from membership to the Commission's sanctions against manipulation included the prohibition of "fraudulent acts" committed while a member,[94] past fraudulent acts not disclosed in the application for membership,[95] effecting of fictitious transactions or the execution thereof with

87. R.J. Koeppe & Co. v. S.E.C., 95 F.2d 550 (7th Cir. 1938).

88. *Ibid.;* Opinion of General Counsel, *supra* note 81.

89. *Hearings,* 3177 ff.

90. Matter of White, Weld & Co., 3 S.E.C. 466, 541 (1938).

91. *Ibid.;* Matter of Russell Maguire & Co., 10 S.E.C. 332 (1941).

92. Opinion of the Director of the Trading and Exchange Division, Exch. Act Rel. Nos. 3505 and 3506 (11/16/43); Matter of Barrett & Co., 9 S.E.C. 319 (1941); Matter of Masland, Fernon, & Anderson, 9 S.E.C. 388 (1941); Matter of W.S. Wien & Co., Exch. Act Rel. No. 3855 (9/17/46); Letter of Director of Trading and Exchange Division, 11/21/50, p. 2; *see* Geismar v. Bond & Goodwin, 40 F. Supp. 876 (S.D.N.Y. 1941).

93. Cases cited *supra* note 79.

94. CONSTITUTION, Art. XIV, § 1.

95. *Id.* § 2.

knowledge of their falsity,[96] demoralization of the market by the use of fictitious transactions,[97] and conduct inconsistent with just and equitable principles of trade.[98] Any violation of the Securities Exchange Act is *ipso facto* conduct inconsistent with just and equitable principles of trade.[99] In addition it is probable that any violation of § 9(a)2 is sufficient cause for the revocation of membership of a manipulator in the National Association of Securities Dealers.[100]

*Investigation by the Commission.*—Administration of the anti-manipulative sections of the Exchange Act is lodged in the Section of Stabilization and Manipulation, in turn a part of the Branch of Trading Practices and Exchange Markets of the Trading and Exchange Division.[101] As of 1949, this section scrutinizes the price movements of 3500 securities traded on the exchanges and 5000 of the most active over-the-counter securities, and also the publishing of earnings statements, declaration of dividends, publication of financial news items, the granting of options, etc., to ascertain whether any rational explanation exists for price movements.[102] In addition, 800 securities were kept under special observation for periods ranging from 14 to 90 days during 1949 because public offerings of substantial blocks of the same security or of related securities of the same issuer were impending.[103] This special observation is appropriate because manipulative activity may be conducted in the outstanding security for the purpose of "facilitating" the distribution of the new offering. The object of this program is the implementation of the Commission's policy of suppressing manipulation at its inception, thus saving the investing public from losses, rather than prosecuting individuals after the manipulative bud has been allowed to burst into full bloom.[104]

If no plausible explanation for prima facie abnormal price movements is discovered from perusal of the other data collected, the Commission institutes a preliminary informal investigation called a "flying quiz".[105] The pendency of a flying quiz is kept confidential[106] for two possible reasons: (1) If no actual manipulation is being conducted, injury to business reputations might result, and (2) News of the Commission's investigation would have a depressing effect on the price of the security. During the entire period from the inception of the Commission to July 1, 1949, 2037

96. *Id.* § 3.
97. *Id.* § 4.
98. *Id.* § 6.
99. *Id.* § 7.
100. See Matter of Aurelius F. DeFelice, Exch. Act Rel. No. 4272 (7/5/49).
101. McCormick, Understanding the Securities Act and the S.E.C. 32 (1948).
102. S.E.C., 15th Annual Report 44 (1949).
103. *Ibid.*
104. *Ibid.*
105. S.E.C., 10th Annual Report 64 (1944).
106. *Ibid.*

flying quizzes were instigated by the Commission.[107] If facts uncovered by the flying quiz justify any sanctions, a formal investigation will be undertaken; or if criminal penalties are thought appropriate by the Commission, the case may be referred to the Department of Justice.[108] From 1934 to 1949, only 192 formal investigations resulted from the flying quizzes instigated.[109] The Commission also receives a considerable number of private complaints concerning violations of the anti-manipulative provisions. These are scrutinized with great care because frequently the complainant has some ulterior motive. It was found that one individual had just sold 2000 shares of a particular stock short and he desired the Commission to investigate so that the adverse publicity would depress the price of the stock, enabling him to cover at a profit.[110]

*Proposed Amendments to § 9(a)2.*—In 1941 bills were introduced in Congress and hearings held for the purpose of amending the Securities Acts. The impetus of the legislation seemed to be dissatisfaction with the allegedly "thin, erratic markets" which existed at the time, the existence of which was blamed upon the Commission's regulation.[111] The Wadsworth bill,[112] which contained all of the proposed amendments to the anti-manipulative provisions of the Securities Exchange Act, contained an amended statement of policy whereby the Commission was given the duty "to encourage and foster orderly, active, stable, and liquid markets for securities upon security exchanges and in the over-the-counter markets. . . ."[113] While this language was innocuous enough, some of the specific amendments to § 9 were latent with possibilities of abuse by prospective manipulators.[114]

Section 203 of the Wadsworth bill restated the requisite manipulative intent as follows: "for the purpose of creating a false or misleading appearance with respect to the market for such security to induce the purchase or sale of such security," and contained a proviso that § 9(a)2 shall not be construed as preventing transactions "effected for the purpose of maintaining a fair and orderly market," *inter alia,* if such transactions were ". . . (a) reasonably necessary for such purpose, (b) not excessive in volume, (c) effected within a reasonable price range, and (d) reported daily to the Commission. . . ." The purpose of these amendments was

107. *Op. cit supra* notes 102, 105.

108. *Op. cit. supra* note 105.

109. *Op. cit supra* notes 102, 105. Extensive statistics as to the number of criminal prosecutions or injunctive or other remedial proceedings have never been compiled due to lack of funds and personnel. Letter of the Director of the Trading and Exchange Division, 11/21/50, p. 2.

110. *Hearings-Amendments,* A, Purcell, 82-84.

111. *Hearings-Amendments,* Explanation of Amendment to § 9(a) 2 of the Exchange Act, at 1409.

112. H.R. 4344, 77th Cong. 1st Sess., (1941).

113. *Ibid.,* Amendment to Exchange Act § 2.

114. REPORT OF THE S.E.C. ON PROPOSALS FOR AMENDMENTS TO THE SECURITIES ACTS, 77th Cong., 1st Sess. 50 (1941) (hereinafter cited as REPORT-AMENDMENTS).

to eliminate the alleged "thin and inactive" markets existing at the time which were supposed to be a result of the reluctance of persons, especially underwriters of new issues, to enter the market because of apprehensions as to the extent of § 9(a)2 as it was written, carrying with it the dire consequence of impeding the flow of capital into industry.[115] The supposed indefiniteness of § 9(a)2 was likened to a reign of terror by the Commission due to the facility of establishing a prima facie case under that section.[116] It was asserted that "market sponsorship" was often required in securities not known nationally, being registered only on the regional exchanges, for the protection of investors in those securities,[117] even after distribution, citing an example of a stock whose market and price collapsed because it was distributed nationally into areas where it was not known.[118] The existing version of § 9(a)2 was also criticized because it deterred the acquisition of large blocks of stock, as such transactions do create an appearance of active trading and raise prices, thus "drying up the markets." [119]

Clarification of an existing statute by public administrative interpretation is a commendable objective, for presumably the expert, impartial Commission will interpret a statute in the manner most consistent with its underlying purpose. As a result of the Congressional hearings it was found that there was substantial agreement on the part of the Investment Bankers Association of America, the National Association of Securities Dealers, the New York Stock Exchange, and the New York Curb Exchange, that attempts to rewrite the statute should be dropped in favor of the public issuance of interpretative rulings and opinions to clarify any ambiguities.[120] But there appears small justification, if any, to the claims that the statute as written was too ambiguous; certainly the effort produced by Mr. Wadsworth was no improvement with its double-barreled criterion of intent and the four requirements of transactions for the purpose of "establishing a fair and orderly market," especially "(a) reasonably necessary for such purpose, (b) not excessive in volume, . . . (and) (c) effected within a reasonable price range. . . ."

Substantively, the proposed addition to § 9 was of course designed to weaken the sanctions against manipulation, characterized by the Commission as "the most important safeguard afforded investors by the Act." [121] The addition to the statement of manipulative intent, i.e., "for the purpose of creating a false or misleading appearance with respect to the market for such security . . ." would legalize the classic defense of the manipulators that they were merely "correcting" a price that was too low and thereby not creating any false appearance.[122] This is patently undesirable

115. H.R. 4344, § 203(a), Statement of Purpose.
116. *Ibid.*
117. *Hearings-Amendments,* Smith, at 1341.
118. *Hearings-Amendments,* Twombly, at 1456 *et seq.*
119. *Hearings-Amendments,* Geer, at 1359.
120. *Hearings-Amendments,* Purcell, at 1491; REPORT-AMENDMENTS, Discussions of H.R. 4344, at 42.
121. REPORT-AMENDMENTS, Discussion of H.R. 4344, at 50.
122. *Ibid.*

since the collective judgment of all bona fide buyers and sellers as to the correct price level is the only determinant of price in a free security market. It should not be seriously contended that any interference with the operation of a free security market is objectionable per se, no matter what socially desirable objectives might be accomplished,[123] but here the sole benefit seems to be in the manipulator's profits. Approximately the same criticism should be leveled at the provision allowing the establishment or maintenance of a "fair and orderly market", at least insofar as any transactions might be conducted for the purpose of raising the price of the security. The maintenance of such a market appears to mean "pegging" at a certain level which is legalized by the existing § 9(a)6, unless prohibited by the Commission regulation, though profiting from any rise in price produced by the pegging might violate § 9(a)2.[124]

It seems desirable that no change in the language of the anti-manipulative provisions of the statute be made. The claim that it is ambiguous is groundless. Since 1941, public administrative interpretations have been made pursuant to the program concurred in by the representatives of the securities industry at the 1941 hearings,[125] and this of course should be continued. The damaging of a broker's financial reputation by a groundless investigation charging manipulative activities is not to be justified lightly, but under settled interpretations of the statute promulgated by the Commission, such a happening seems highly improbable; and at any rate preliminary investigation is kept confidential. And the concept of free and open security markets leaves no room for the correction of "thin" markets, if no one desires to trade, unless there is some extrinsic socially desirable end which will be prejudiced thereby. Manipulative operations were frequently excused on the ground that they were "making" or "sponsoring" a market for the benefit of existing holders of the security.[126] The averment of such a philanthropic purpose suggests the question as to the source of the manipulator's funds necessary to carry on such an operation. The answer is shown by experience: he expects to unload stock acquired at a low price to the investing public at the price level to which his sponsorship carried it, and then he ceases to support the market, letting it drop to the uninspired levels from whence it came. The basic fact that someone has to pay for the "sponsorship" must not be forgotten.

### Activities Lawful Unless Prohibited by Commission Regulation

Transactions involving puts, calls, and other options, short sales, and matched orders, and the employment of "manipulative and deceptive de-

123. See the Commission's Statement of Policy Concerning Stabilization, Exch. Act Rel. No. 2446 (3/18/40).

124. See section entitled "Stabilization," *infra*.

125. *E.g.*, Opinion of the Director of the Trading and Exchange Division, Exch. Act Rel. Nos. 3505 and 3506, (11/16/43).

126. See note 89 *supra*.

vices", are not prohibited by the Exchange Act but are made subject to rules and regulations of the Commission prescribed as "necessary or appropriate in the public interest, or for the protection of investors." Categorically speaking, "pegging, price fixing, and stabilizing" is includible here but the different nature of the problems and the relative importance thereof merit separate treatment.

*Options.*—Options are of two general types: puts and calls. A put is a negotiable document giving the holder the right to sell a given security to the maker at a given price within a given period of time.[127] A call gives the holder the right to buy a given security from the maker at a given price within a given period of time.[128] It follows that in order to be profitable for the holder to exercise a put the price must decline a sufficient amount below the price named in order to cover the consideration paid for the put, if any; and, conversely, in order to exercise a call profitably, the price must rise above the call price plus the consideration paid for the call. The two devices are bearish and bullish, respectively.

The call option was usually an indispensable concomitant of pool operations because it enabled the manipulators to enter the market with a large potential supply at a minimum of risk.[129] Such calls were usually granted either by the issuer or by directors or large stockholders gratuitously, or perhaps for a small fraction of the pool profits.[130] During the period 1929-1933, there were 286 options on stocks listed on the New York Stock Exchange of more than 10,000 shares each, indicating the widespread use of them in pools.[131] In addition the pools used to lure speculators into entering the market on the long side by granting puts so as to put a floor under their losses and thereby stimulate activity outside of the intra-pool trading.[132] Sometimes the pool itself would obtain a put so as to insure itself against loss. In the case of a bear pool the whole procedure would be reversed; a put would be used to provide demand and calls to insure against loss would be used by the pool itself and to lure speculators into selling short. Exchange rules requiring the reporting of options granted to members proved insufficient because the options would be granted to non-members.[133]

However, some uses of options unquestionably have economic value.[134] It has never been suggested that there is anything wrong with insuring oneself against loss. Options perform this function at a very small cost.

127. *Hearings,* Corcoran, at 6515.

128. *Ibid.*

129. REPORT at 45, TWENTIETH CENTURY FUND, THE SECURITY MARKETS 463 (1935).

130. REPORT, at 36.

131. REPORT, at 45.

132. REPORT, at 36; *Hearings,* Cutten, at 5908.

133. SENATE COMMITTEE ON BANKING AND CURRENCY, SEN. REP. No. 792, 73d Cong., 2d Sess. (1934).

134. See *Hearings,* Corcoran, at 6517, Redmond, at 6516, Filer, at 7062 *et seq.*

A person who wishes to protect his long position may do so by purchasing a put. Should the market decline he may demand that the maker of the put buy from him. Similarly, one who has sold short may protect his position by acquiring a call.[135] In the event of a rise he may cover by demanding that the maker sell to him at the call price. Certainly if use of these devices were very widespread their stabilizing influence on the market would be considerable.[136] Speculators may also enter the market by the use of puts and calls at prices far below the margin requirements. There are specialized dealers in the industry who originate puts and calls in sufficient number and at sufficient prices to net them a profit, and these persons are the source of supply for legitimate options.[137]

While it was recognized that there was nothing immoral or illegal about an option for a large number of shares of stock, the striking adaptability of the device to the needs of manipulators prompted the suggestion in 1934 that options should be prohibited since it was difficult to detect manipulation, at least in its inception.[138] However, it was equally recognized that options had legitimate uses, probably of some economic value. The original draft of the Exchange Act prohibited options entirely on the premise that it was impossible to distinguish between good and bad options; therefore a balance of convenience demanded that they be prohibited entirely.[139] Congress, however, recognized that options were lawful per se and gave the Commission power to regulate them in the statute.[140] However, registered rights and warrants were exempted from the definition of the call.[141] No regulations have ever been issued under these sections because there has not been a sufficient frequency of misuse of options to warrant the Commission in so doing.[142] It was suggested that the reporting of the grant of options might be an appropriate regulation,[143] but such information is already available through the reports required of corporate insiders.[144] The Rules of the New York Stock Exchange forbid dealing in puts and calls on the floor,[145] or effecting any transaction in a stock for an account in which a member is interested, if the member or his firm has granted or holds any option in that stock. These provisions were apparently designed to prevent exchange facilities from being used to further a manipulative pool's activity.[146] It

135. Report, at 51.

136. *Hearings,* Filer at 7062 *et seq.*

137. *Ibid.*

138. House Committee on Interstate & Foreign Commerce H.R. Rep. No. 1383, 73rd Cong., 2nd Sess. (1934).

139. *Hearings,* Corcoran, at 6515.

140. Exchange Act § 9(b).

141. Exchange Act § 9(d).

142. Letter of Director of Trading and Exchange Division, 11/21/50, p. 2.

143. Mathias, *Manipulative Practices and the Securities Exchange Act,* 3 U. of Pitt. L. Rev. 7, 24 (1936).

144. Exchange Act § 16(a).

145. Rules of the Board of Governors, Rule 129.

146. *Ibid,* Rule 371.

is submitted that very little gain would result from any regulations under the statute at the present time, and an appreciable cost might be incurred in the hampering of the use of options for legitimate purposes.

*Short Sales.*—A short sale may be defined as a sale of a security which the seller either does or does not own, if delivery of the security is consummated by borrowing it for the account of the seller.[147] The seller's broker usually borrows the security from another broker, depositing an amount equivalent to the market value of the stock.[148] The borrowed stock is in effect returned when the seller effects a covering purchase, and the deposit is returned. Theoretically there is no time limit for covering purchases except the seller's patience and fortitude. The raison d'etre of a short sale, of course, is an expected drop in price which will enable the short seller to cover at a low figure and profit by the difference between that figure and the price at which he sold short. The short seller may protect his position by acquiring a call at the short sale price.[149] Although a short seller does not actually sell his stock when he effects a sale, and the transaction is in effect a sale of stock to be delivered in the future, though at an indeterminate time, a short sale is not a fictitious transaction because the short seller represents that he is willing to sell at the short sale price, although he hopes to buy later at a reduced price.[150]

Much ink has been spilled by stock market apologists over the alleged economic benefits of the short sale.[151] These may be summarized as follows: (1) short selling "cushions" the declines by forcing compulsory buyers into the market to cover their sales, (2) It has a retarding effect in a bull market, and (3) It allows a two-sided market reflecting a consensus of optimistic and pessimistic views. Any other advantages are of a minor nature, some of which are applicable only to technical short sales. In practice the principal alleged advantages have proved to be non-existent or in some cases diametrically incorrect. The fallacies of the cushion theory are twofold: first, short selling has an initial depressing effect which is not likely to be compensated by later covering because the depressing effect probably induced those who were long to sell, touching off stop-loss orders; therefore, the selling pressure is far greater than the subsequent buoyant pressure of short covering; second, short sellers, being rational people, usually do not cover until the bottom of the decline is in sight, or until recovery commences, in order to maximize their profit.[152] Accordingly the effect of short selling is to exaggerate, rather than to retard, any

147. EXCHANGE ACT, Rule X-3B-3.

148. REPORT, at 50.

149. *Ibid.*

150. Berle, *Liability for Stock Market Manipulation*, 31 COL. L. REV. 264, 271 (1931).

151. REPORT, at 53; DICE AND EITEMAN, THE STOCK MARKET 181 (1941); TWENTIETH CENTURY FUND, THE SECURITY MARKETS c. XI (1935).

152. REPORT, at 53.

downward price movement.[153] This conclusion was corroborated by an intensive study of the recession in the fall of 1937 conducted by the Commission.[154] The theory that short selling has a retarding effect in a bull market is likewise a figment of the imagination. Short sellers, being bears, hibernate during the bull markets, and accordingly their activities have no effect in stemming price rises.[155] In fact a large volume of short selling might ultimately result in the accentuation of a bull movement, at least in its early stages, because of the covering purchases of those who sold short during the previous decline. And as for the "two-sided" market theory, it was shown that prior to 1934 the volume of speculative short selling was only 5% of the speculative long position.[156] Therefore during a normal market the short sale is not a very important factor. Most of its real advantages appear in facilitating the functions or arbitrageurs and odd-lot dealers.[157] The abuse of short selling in connection with manipulation lies in the fact that the short sale was the tool of the bear pools.

Congress was cognizant of the conflicting views and the admitted useful functions of the short sale and appropriately left the matter to Commission regulation.[158] The study conducted by the Commission during the 1937 recession prompted it to enact a comprehensive system of regulation of short sales.[159] The backbone of the regulation is a prohibition of such sales below the last "regular way" sale price or at such last sale price unless it was above the next preceding different sale price.[160] Regular way signifies a sale in exchange parlance in which the security must be delivered on the third business day following the transaction.[161] Short sales on a scale down, for the purposes of bear-raiding, or merely to follow an extraneous price decline with the hope of covering at the bottom, are effectively prohibited. Sales by odd-lot dealers and arbitrageurs are excepted from the operation of this prohibition, however.[162] For the purposes of this regulation it is immaterial whether the last regular way sale price was the result of a long or a short sale.[163] The remainder of the rule is concerned with proper identification of sell orders, and the covering of long sales improperly executed as short sales.[164] The propriety

153. REPORT, at 53; TWENTIETH CENTURY FUND, THE SECURITY MARKETS c. XI (1935).

154. S.E.C., TENTH ANNUAL REPORT 42 (1944).

155. REPORT, at 54.

156. TWENTIETH CENTURY FUND, THE SECURITY MARKETS c. XI (1935).

157. See DICE AND EITEMAN, THE STOCK MARKET 181 (1941).

158. EXCHANGE ACT § 10(a).

159. See note 154 *supra*. Rules X-10A-1 and X-10A-2 were the result of this study.

160. Rule X-10A-1(a).

161. NEW YORK STOCK EXCHANGE, RULES OF THE BOARD OF GOVERNORS, Rules 109 and 112.

162. Rule X-10A-1(d).

163. Partial Text of a Letter of the Secretary of the N.Y.S.E. to Members, Relating to Rules X-3B-3, X-10A-1, and X-10A-2, concurred in by the Director of the Trading and Exchange Division, Exch. Act Rel. No. 1571 (2/5/38).

164. Rules X-10A-1(b), (c); X-10A-2.

of the regulations of the Commission is fortified by the fact that they have stood unamended for 10 years. In view of the evidence of the effects of short selling in a declining market gathered during 1934 and 1937, it is submitted that the prohibition of short selling on a scale down adopted is the most effective way to counter the depressing effect of short sales in a declining market, and does not hamper any of the legitimate functions of short selling.

*Stop-loss orders.*—Stop-loss orders are directions to a broker to either sell or buy if the market rises or declines to a certain level.[165] Since when given they are usually several points off the market, their execution is entrusted to the specialist in the particular stock. Should the market reach the price named in the order, the latter becomes a market order and must be executed at the best price obtainable.[166] Despite the name, stop-loss orders are used both for limiting loss and protecting profit.[167] Stop-loss orders to sell are used by those who have a long position and wish to limit loss or protect profit in the event of a decline; stop-loss orders to buy are used by those who are short and wish to protect themselves against a rise.[168]

Stop-loss orders have been condemned because they produce "terrific breaks in stocks." This is so because the specialist is obligated to execute a stop-loss order at the best price obtainable the moment the stock declines to the order price, and if there are a number of stop-loss orders being activated simultaneously, the market is going to be flooded with sell orders.[169] The nexus between stop-loss orders and manipulative activity is that the existence of a large number of stop-loss orders, which were recorded on the specialist's books, was an aid, albeit inadvertent, to the operation of both bull and bear pools.[170] All that the bear pools had to do was to drive the price down to the level of the stop-loss orders by short selling, and the remainder of the decline would take care of itself. It was a practice for bull pools to start bearish in the same manner for the purpose of acquiring a large supply of the stock to be manipulated at a low price.

However, the aid given to manipulators by stop-loss orders was patently inadvertent since the originators of the stop-loss orders stood to lose by the operation of the pool. Accordingly Congress left the regulation of stop-loss orders to the Commission.[171] No regulations have ever been issued, however, probably because of recognition of the fact that the stop-loss order is a perfectly legitimate device. There seems to be no present reason for departing from this policy.

165. *Hearings*, Wright, at 6097; see Alexas v. Post and Flagg, 129 S.C. 53, 123 S.E. 769 (1924).

166. *Hearings*, Wright, at 6097-98.

167. Loss, Cases and Materials on S.E.C. Aspects of Corporate Finance 79 (1947).

168. *Ibid.*

169. See note 166 *supra*.

170. See text at notes 65-69 *supra*.

171. Exchange Act § 10(a).

*"Manipulative and Deceptive Practices."*—Sections 10(b) and 15(c)1 of the Exchange Act grant the Commission rule making authority to define and regulate the use of "manipulative and deceptive practices." These sections, together with § 17(a) of the Securities Act, which outlaws the employment of fraudulent devices, obtaining of property by false statements, or engaging in a course of conduct which operates as a fraud on purchasers, are collectively known as the anti-fraud provisions of the Sesecurities Acts, and manipulative conduct, being a species of fraud, may be punished under any one or all of these sections, since for this purpose it is immaterial whether the securities are registered or not, or whether the transactions are effected on an exchange or over-the-counter.[172] The terms "manipulative, deceptive, and other fraudulent device or contrivance" has been defined as any course of conduct which operates as a fraud upon any person, including untrue statements of or omissions to state any material fact, if there are reasonable grounds to believe the untruth or misleading nature of the statements.[173] This definition, which accords substantially with the provisions of § 17(a) of the Securities Act, has been sustained as against a charge of unconstitutional indefiniteness.[174] Other rules promulgated under the anti-fraud provisions state that failure to disclose control of the seller by the issuer is an omission to state a material fact, and prohibit the effecting of any sales represented to be "at market" by a broker or dealer unless he knows or has reasonable grounds to believe that a market exists for the security other than that made or created by him.[175]

It has been held that any course of conduct which would violate § 9(a) if effected in a registered security constitutes a manipulative device for the purposes of § 15(c)1 and Rule X-15C1-2.[176] And the requirement of a "series of transactions" raising or depressing the price of a security as stated in § 9(a) is satisfied by the placing of bids in the over-the-counter market, without any proof of actual purchases or sales.[177] However, the mere procuration of agreements from holders of large blocks of the security being distributed not to enter the market for 60 days was held not to be an objectionable manipulation per se.[178] When the manipulator subsequently distributes the security to the public, however, representing it to be "at market", such conduct is an independent violation of the anti-fraud provisions because the failure to disclose that the price in the market is a result of his own activities rather than the operation of free forces of supply and

172. See EXCHANGE ACT §§ 10(b), 15(c) 1, and Rules X-10B-1, X-10B-3, and X-15C1-1 to 8, inclusive.

173. Rule X-15C1-2.

174. Hughes & Co. v. S.E.C., 139 F.2d 434 (2d Cir. 1943), *cert. denied,* 321 U.S. 786 (1944).

175. Rules X-15C1-5 and 8, respectively.

176. Matter of Barrett & Co., 9 S.E.C. 319 (1941); Matter of Masland, Fernon, and Anderson, 9 S.E.C. 388 (1941); see S.E.C. v. Otis & Co., 18 F. Supp. 100 (N.D. Ohio 1936), *aff'd,* 106 F.2d 579 (6th Cir. 1939).

177. Cases cited note 79 *supra.*

178. S.E.C. v. Otis & Co., *supra* note 176.

demand is an omission to state a material fact.[179] This requirement of disclosure has been extended to conduct which is not manipulative per se but which interferes with either supply or demand, or both, *e.g.*, failure to disclose agreements on the part of holders of large blocks of the same security not to enter the market.[180] Similarly, failure to disclose past or proposed manipulation, or other artificial factors affecting the market constitutes a defect in the registration statement under the Securities Act.[181]

Efforts in 1941 to amend these sections were aimed at providing more certainty and preciseness of definition of prohibited conduct by Commission rule, and prescribing a rule of construction in favor of the accused persons.[182] The Commission observed that the only purpose served would be to aid those of questionable repute to find loopholes, and analogized the situation to the refusal of the courts to rigidly circumscribe common-law doctrines of fraud.[183] It is submitted that their position in the matter is unassailable.

One problem of interpretation exists, however. Rule X-15C1-8 prohibits sales "at market" by any broker or dealer interested in a distribution of securities over-the-counter unless he knows or has reasonable grounds to believe that a market exists other than that made or controlled by him. Apparently disclosure of the control over the market alone will not excuse the sale. Yet under the stabilization section of the statute and the rules thereunder the same conduct is permissible if effected in a registered security on the exchange, providing appropriate disclosure is made, if the only interference with the market is stabilization to prevent or retard a decline.[184] A possible justification of this inconsistency might be the fact that the actual prices at which transactions are effected over-the-counter are not known; only the "bid" and "asked" prices are customarily published. However, it is submitted that for the sake of consistency the same kind of market interference should be allowed both on the exchange and over-the-counter.[185] This result might be reached by construing the language "a market made or controlled by him" in Rule X-15C1-8 to exclude stabilization activities that would be permissible under Regulation X-9A6-1.

*Special Offering Plans.*—Rule X-10B-2 provides in general that the paying of compensation by any person interested in a primary or secondary

179. Matter of Barrett & Co., *supra* note 176; Matter of Masland, Fernon, and Anderson, *supra* note 176; Thompson Ross Securities Co., 6 S.E.C. 1111, 1121 (1940); Matter of Thornton & Co., Exch. Act Rel. No. 4115 (7/15/48); Matter of S.T. Jackson & Co., Exch. Act Rel. No. 4459 (6/23/50); Matter of Russell Maguire & Co., 10 S.E.C. 332 (1941).

180. S.E.C. v. Otis & Co., *supra* note 176.

181. *E.g.*, Rickard Ramore Gold Mines, Ltd., 2 S.E.C. 377 (1937); Canusa Gold Mines, 2 S.E.C. 548 (1937); Austin Silver Mining Co., 3 S.E.C. 601 (1938); Thomas Bond, Inc., 5 S.E.C. 60 (1939); Potrero Sugar Co., 5 S.E.C. 982 (1939).

182. *E.g.*, additions to SECURITIES ACT § 17(a) and EXCHANGE ACT § 15(c) contained in H.R. 4344, 77th Cong., 1st Sess. (1941).

183. REPORT-AMENDMENTS.

184. Regulation X-9A6-1.

185. *Cf.* dissenting statement of Comr. Healy to the Commission's Statement in re Stabilization, Exch. Act Rel. No. 2446 (3/18/40).

distribution of securities to another for the purpose of soliciting purchases of any security of the same issuer, or for purchasing any security of the same issuer, on any national securities exchange, for any account other than the payor of the compensation, is a manipulative or deceptive device and is accordingly prohibited; and any sale of the same security or delivery of it after sale, if any of the above acts were done, is further prohibited. It is immaterial for the purposes of this regulation whether the solicitation is to purchase stock held by the person paying the compensation or by some other person.[186]

It was provided in this rule, however, that special offering plans for securities registered on an exchange may be submitted by the exchange and if approved by the S. E. C. are excepted from its requirements.[187] The purpose of a special offering plan is to facilitate rapid distribution of a large block of stock when the ordinary auction market could not absorb it without undue price disturbance.[188] Both selling and buying commissions, which may be larger than ordinary, are usually paid by the seller; full disclosure of the plan must be made to the buyer.[189] The amended special offering plans of three exchanges approved in 1949 allow the seller to allot 50% of the offering on a firm basis to member firms for distribution; the latter are allowed to retain the special commission if they are forced to carry the securities for their own account in the event of inadequate public demand; and should demand exceed supply those who took on a firm basis are not required to allocate their supply to the unfilled orders placed with other firms, as was formerly the case.[190] The exchanges are also given greater discretion in the approval of special offerings pursuant to their plan; price movements and volume of trading during the last month only are to be taken into account in making the determination. Delegation of this function to the exchanges seems to be desirable as long as retention of jurisdiction over the plan itself is retained by the Commission, since the exchanges are probably more cognizant of demand and will be better able to predict the success of a particular offering.

### STABILIZATION

Stabilization of security prices is a device commonly used by investment bankers to facilitate the distribution of securities to the investing public. Before embarking upon a discussion of the mechanics of stabilization or its regulation by the Commission, a brief picture of the development and the present structure of investment banking is appropriate.

186. Opinion of the Director of the Trading and Exchange Division Relating to Rules X-15C1-6 and X-10B-2, Exch. Act Rel. No. 1411 (11/15/37). Rules X-10B-2 and X-15C1-6 are identical.

187. Rule X-10B-2(d).

188. S.E.C., TENTH ANNUAL REPORT 43 (1944); INVESTMENT BANKERS ASSOCIATION OF AMERICA, FUNDAMENTALS OF INVESTMENT BANKING 462 (1947).

189. S.E.C., TENTH ANNUAL REPORT 43 (1944).

190. Amended Special Offering Plans of New York Stock Exchange, New York Curb Exchange, and San Francisco Stock Exchange, Exch. Act Rel. Nos. 4299, 4309, and 4343 (1949).

*Investment Banking Methods.*—The function of the investment banker or underwriter is to gather private capital to supply the needs of industry.[191] Ordinary industrial corporations can spare neither the time nor the expense, nor can they assume the risk, of marketing their own securities to the public. Should a corporation decide that a certain program of expansion is necessary, it naturally desires to be assured of a certain sum on a certain date at a minimum cost to it.[192] In some limited cases a corporation will be able to sell an entire issue directly to a large institutional investor, such as a life insurance company. This procedure is not available for the majority of securities which do not meet the stringent requirements for investment in this type of enterprise. The investment banker, or underwriter, will then perform the distribution and assumption-of-risk functions for the issuing corporation.

Prior to 1916, underwriting procedure in the United States involved the buying of the entire issue by the originating underwriter from the issuer at a fixed price and reselling to other underwriters to distribute the risk (underwriting syndicate), the originating underwriter acting as sales manager for the group.[193] Distribution commonly took from one to two years and the spread, *i.e.*, the difference between the price realized by the issuer and the price to the public, was large. In England the underwriter lived up to his name. The issuer itself assumes the task of distribution, the English public being educated to buying securities on the basis of the prospectus supplied by the issuer. If any part of the issue is not subscribed, the underwriters are obliged to purchase it at a fixed price. If forced to do so, they do not usually dispose of the securities immediately, but retain them until buyers can be found at the issue price or at a small discount.[194] Of course this method frequently ties up large parts of the underwriter's capital for a considerable period of time.

The origination of an issue in the United States underwent some basic changes in the period after the first World War. Increasing demand by industry for capital for purposes of expansion and increasing demand by the public for securities apparently caused underwriters to reduce the spread and to distribute the securities with great haste; they could not afford to immobilize their capital for very long in any one issue because of the large number of issues underwritten.[195] Present day underwriting procedure is as follows.[196] The originating underwriter negotiates the

191. Investment Bankers Association of America, *supra* note 188 at 353.

192. Statement of the Commission, Exch. Act Rel. No. 2446 (3/18/40).

193. See Matter of N.A.S.D. (S.E.C. 1945).

194. *Hearings*, Untermyer, at 7737; Dissenting statement, Exch. Act Rel. No. 2446 (3/18/40).

195. Eight leading underwriters in the United States participated yearly in an aggregate value of securities from 4.11 to 23.83 times as large as their invested capital. Dissenting statement, Exch. Act Rel. No. 2446 (3/18/40).

196. Compare Matter of N.A.S.D. (S.E.C. 1945); Report at 93-95; *Hearings-Amendments*, Twombly, 1456 *et seq.;* Prospectus, 160,000 shares Standard Railway Equipment Mfg. Co. Common Stock, 10/17/50, at 17 *et seq.;* Exchange Act Rel. No. 2446 (3/18/40).

terms of the issue with the issuer, *e.g.*, what kind of security is best adapted to the needs of the corporation, and what kind is best acceptable on the market. The approximate price to the issuer and the spread are decided. The originator then forms the underwriting syndicate, taking up about 10-20% of the issue itself and allotting the remainder to the syndicate members. The latter sell about 50-60% of the issue for their own account, and the balance is placed with the selling group by the originator, for purposes of control, to be sold for the account of the underwriting syndicate. Upon this amount the commissions are split between the selling group members and the underwriters. Meanwhile the originator has submitted the registration statement to the Commission, and about one or two days before the effective date thereof the actual contract is signed by the issuer and the originator, and the offering price decided, which is usually accepted by the Commission as an amendment as a matter of course. The originator is then bound to deliver to the issuer the stipulated amount of capital at the stipulated time. The terms of the agreement between the underwriters and the selling group members reserve to the originator the right to redistribute any part of the issue that is not selling well, and also the right to effect stabilizing transactions for the account of the syndicate, sometimes not over a certain percentage of the entire issue. Members of the underwriting and selling groups are specifically directed not to trade in, or bid for, the security being offered for their own account. They are also forbidden to trade as agent on unsolicited orders for the account of others.

*Mechanics of Stabilization.*—[197] Stabilization may be defined as purchasing by the syndicate manager (originator) of the security being distributed, for the account of the syndicate, for the purpose of maintaining the price or preventing a decline. Since the securities purchased in the stabilization process must be resold if the distribution is to be successful, either of two procedures will be necessary: (1) the syndicate manager will overallot to the members of the underwriting and selling groups to the extent of 10%; therefore, if the latter sell their entire allotment there will be a 10% short position which will be covered by the stabilizing purchases, or (2) upon purchase of the security for the purpose of stabilization, the syndicate manager re-allots it to the underwriter or selling group member who originally sold it, and the latter forfeits his commission. This method was conceived to combat the practices of some unscrupulous selling group dealers who undercut the public offering price. The effecting of stabilizing purchases is done by placing a bid equal to the public offering price on the exchange and in the over-the-counter market. Of course, if the issue is unpopular or "sticky", it may be necessary to drop the stabilizing bid slightly. Stabilizing cannot be used in the face of a general price decline because the cost would be prohibitive.

If there are outstanding prior to the distribution securities of the same issuer which are similar in terms to that being offered, it is the practice to

197. *Ibid.;* see also ATKINS, EDWARDS, AND MOULTON, THE REGULATION OF THE SECURITY MARKETS c. VI, III (1946).

stabilize these securities also in order that the new issue will compare favorably with that already outstanding.[198] Similarly, if securities of the same class as those being offered are already outstanding in any appreciable quantity, the originator will secure agreements from the holders not to enter the market pending the distribution.[199]

*Arguments in Favor of Stabilization.*—Underwriters and stock market apologists have advanced several arguments in justification of stabilization. Primarily, it is asserted that stabilization is necessary to neutralize a temporary condition of oversupply, resulting from the fact that demand for a security is dependent to a large degree upon knowledge of its merits and the record of the issuer.[200] In support of this argument it is pointed out that during a reasonable time after distribution most stabilized issues attain a price substantially equal to or above the offering price.[201] The second real argument lies in the necessities of the situation, *i.e.*, the lack of ability of American underwriters to immobilize large amounts of their capital while waiting for the public to buy at the offering price.[202] It is asserted that prevention of stabilization would seriously burden the flow of capital into industrial expansion, because underwriters would be forced to accept fewer commitments and charge higher spreads, assuming that their capital remains constant.[203] The remainder of the arguments seem to be of a makeweight nature. It is contended that stabilization gives purchasers who change their mind a chance to liquidate their investment immediately without loss, and is necessary to combat the activities of short-term speculators who sell out upon being disappointed at the lack of an immediate profit.[204] Arguments that the underwriters have an obligation to "provide a market", and that stabilization "aids distribution" by placing the securities in the hands of ultimate investors instead of speculators, seem to be variations on the same theme.[205] Stabilization during secondary distributions is justified on the ground that otherwise investors would be unwilling to take up any substantial block of an issue upon primary distribution because of the resultant impairment of liquidity.[206]

*Arguments Against Stabilization.*—The traditional cry of the reformers is that stabilization is a form of manipulation and is *ipso facto* objectionable

198. REPORT at 100.

199. *E.g.*, Matter of Michael J. Meehan, 1 S.E.C. 238 (1935); Reiter-Foster Oil Corp., 6 S.E.C. 1028, 1048-51 (1940).

200. *Hearings-Amendments*, Twombly, 1456 *et seq.*; Exchange Act Rel. No. 2446 (3/18/40).

201. Exch. Act Rel. No. 2446 (3/18/40); *cf.* subtitle "Statistics" under this section, *infra*.

202. See both majority and dissenting statements in Exch. Act Rel. No. 2446 (3/18/40).

203. *Ibid.*; see also ATKINS, EDWARDS, AND MOULTON, *op cit. supra* note 197.

204. REPORT at 98; *Hearings*, Whitney, at 6631; ATKINS, EDWARDS, AND MOULTON, *op. cit. supra* note 197.

205. *Hearings*, Kahn, at 1119-20, 1124.

206. Exch. Act Rel. No. 2446 (3/18/40).

as an interference with the free forces of supply and demand.[207] In the language of the Commission, this statement "poses the problem but does not answer it." [208] It is further argued that stabilization by definition creates an artificial appearance of stability of the issue, deceiving investors who assume that public demand is maintaining the price.[209] It is pointed out that buying back the issue at the offering price during distribution confers no benefit upon genuine investors, as contrasted to speculators.[210] The haste and high-pressure tactics which accompany the entire distribution precludes educated buying by both the dealer or broker and his customers.[211] Stabilization which is continued after the distribution is subject to the additional criticism that it creates a fictitious credit rating for the issuer.[212] The most serious objection seems to be that upon completion of distribution and termination of stabilization a sharp decline in price usually ensues, which is never recovered.[213] The Congressional investigating committee uncovered several bad examples of this phenomenon involving the distribution of foreign bonds, which apparently influenced their conclusion.[214]

*Section 9(a) 6.*—The conflicting arguments enumerated above and the lack of conclusiveness of the evidence adduced before the legislative committees as to the value of or the detriment produced by stabilization prompted a recommendation that the problem be left to Commission regulation, and so it was in the statute.[215] Counsel for the investigating committee stated that the failure to outlaw stabilization was in deference to the argument that making a market at the issue price was beneficial, especially since the Government commonly engaged in the practice with its bonds.[216] The accepted concept of stabilization as interpreted by the Commission is that "stabilization for the sole purpose of retarding a decline, or preventing it, whether the stabilization is effected by an underwriter or by an issuer, does not of itself violate §9(a)2 or any other section of the Securities Exchange Act . . .," whereas activities designed to raise or lower prices are clearly manipulation and prohibited by § 9(a)2.[217] Stabilization is thus a negative form of manipulation.

207. The most forceful exponent of this view was the late Comr. Healy; see his dissent to Exch. Act Rel. No. 2446, (3/18/40).

208. Statement of the Commission, Exch. Act Rel. No. 2446 (3/18/40).

209. REPORT, at 95, 99.

210. REPORT, at 98.

211. REPORT, at 100.

212. REPORT, at 99

213. REPORT at 97; cf. materials cited note 201 *supra*.

214. *E.g.*, German 5½s floated at 90 by J. P. Morgan & Co., which dropped from 90 to 86 upon pulling the peg; Chile 6½s floated at 97 by Kuhn, Loeb & Co., which fell to 74.

215. SENATE COMMITTEE ON BANKING AND CURRENCY, SEN. REP. No. 792, 73d CONG., 2d Sess. (1934); HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, H.R. REP. No. 1383, 73d Cong., 2d Sess. (1934).

216. *Hearings*, Pecora, at 7736.

217. Notice of Proposal to Regulate Stabilization of Security Prices, Exch. Act Rel. No. 4163 (9/16/48).

At the time of the passage of the Securities Exchange Act some authorities were of the opinion that stabilization, as a form of price fixing in interstate commerce, violated §1 of the Sherman Act.[218] This problem has never been squarely decided by court or commission; however in an advisory opinion rendered in 1945 the Commission concluded that even if stabilization was considered an interstate restraint of trade, it was probably a lawful, reasonable restraint, especially since it was usually of short duration.[219]

*Disclosure in Registration Statement and Prospectus.*—Even before any stabilization rules were promulgated by the Commission, it was of the opinion that failure to disclose stabilizing activities in the prospectus was objectionable.[220] Rule 426 of the Securities Act, subsequently issued, provides that if the underwriters intend to stabilize the price of any security to facilitate the distribution, the following statement must appear in large type on the front cover, inside or outside:

> "In Connection With This Offering, the Underwriter May Effect Transactions Which Stabilize or Maintain the Market Price of (security) at a Level Above That Which Might Otherwise Prevail in the Open Market. Such Transactions May Be Effected On (exchange). Such Stabilization, if Commenced, May Be Discontinued at Any Time."

If the offering is of a new issue for which there is no existing market, the Commission usually requires expansion of this statement in the body of the prospectus or registration statement to explain that initially at least the stabilizing transactions of the underwriters have a dominant influence in the market; that maintenance of prices will not be the sole result of supply and demand; and that at the expiration of the distribution the market will cease to have the support, if any, of the underwriters.[221] Failure to disclose the existence of stand-off agreements in the registration statement was also held to be materially misleading for this purpose.[222]

*Stabilization of Distributions "At the Market".*—The area in which manipulative abuses had been most prevalent in the pre-1934 era were market offerings, in which the price of the security offered is represented to be at open market prices established by unfettered forces of supply and demand.[223] Accordingly this segment of the area of stabilization was the first

218. Moore and Wiseman, *Market Manipulation and the Exchange Act,* 2 U. of Chi. L. Rev. 46 (1934).

219. Matter of National Association of Securities Dealers (S.E.C. 1945).

220. Opinion of General Counsel of Commission, Exch. Act Rel. No. 605 (4/17/36).

221. McCormick, Understanding the Securities Act and the S.E.C. 261 (1948); see, *e.g.,* Prospectus, 160,000 sh. Standard Rwy. Equipment Mfg. Co. Common Stock, 10/17/50.

222. Reiter-Foster Oil Corp., 6 S.E.C. 1028, 1048-51 (1940).

223. *Hearings-Amendments,* Purcell, at 83-85; Letter of Director of Trading and Exchange Division, 11/21/50, p. 1.

to be regulated by the Commission, in pursuance of its policy of piecemeal, experimental regulation.[224] Before the effectiveness of Rule X-9A6-1, stabilization might have been affected in a distribution at market at prices *above* the initial offering price providing there were independent purchases raising the market price to that level.[225] The new rule[226] precluded stabilization purchases at any price above the last legitimate sale price on the designated exchange, or at that price unless the day's high so far was ½ of 1% or ¼ point higher. The maximum price at which any stabilizing purchase might be effected, irrespective of the above rule, was established at 1 point higher or 102½% of the initial legitimate sale price, whichever is lower. Disclosure requirements include the transmission of a notice of intention to stabilize to the Commission, the inclusion of a statement to every purchaser before the completion of the transaction to the effect that stabilization may have been undertaken or may be undertaken to facilitate the offering in any written communication designed to induce purchases by others, and, if a sale is made over-the-counter, additional written disclosure to the effect that stabilizing transactions have been effected, if such be the fact. Stabilizing transactions designed to raise the price, if effected at a price which has been attained through previous manipulation, are strictly forbidden. These rules apply only to registered securities, but both the securities being offered and those which may be stabilized to facilitate the offering, *e.g.*, other securities of the same issuer, are included.

Rule X-17A-2 requires the filing of reports by stabilizers on every business day of all transactions in the securities being stabilized to the Commission, and also a notice of termination of stabilization, and is applicable to both fixed-price and market offerings. In addition, all persons who must file a registration statement under the Securities Act are obliged to file these reports.

Distributions over-the-counter which are represented to be at market, however, are not subject to these rules. Rule X-15C1-8 forbids sales during a distribution over-the-counter which are represented to be at market, unless the person effecting the sales knows or has reasonable grounds to believe that a market exists other than that made or controlled by the stabilizers. While this language does not demand the conclusion, the authorities concur that stabilization in connection with this type of distribution is in effect prohibited.[227]

Distributions at the market have never been very popular and are very infrequent today; virtually all offerings of substantial size are now of the fixed-price type.[228] According to the Director of the Trading and Exchange

224. Statement of the Commission, Exch. Act Rel. No. 2446 (3/18/40).

225. *Ibid.*

226. Regulation X-9A6-1.

227. Andresen, *Manipulation of the Over-the-Counter Securities Markets,* 10 Geo. Wash. L. Rev. 639, 647 (1942); Parlin and Everett, *The Stabilization of Security Prices,* 49 Col. L. Rev. 607, 609 n.15 (1949).

228. Parlin and Everett, *supra* note 227 at 608.

Division of the Commission, although Regulation X-9A6-1 was used to some extent by underwriters offering listed securities at market when it was first promulgated, stabilization programs thereunder have been virtually non-existent since 1943.[229]

*Stabilization of Fixed-Price Distributions.*—Problems of the stabilization of fixed-price offerings are probably the most practically significant involving the anti-manipulative sections of the securities laws, since virtually all distributions, both primary and secondary, are now of this type,[230] and a large proportion of the registration statements filed contain notice of an intention to stabilize.[231] The only positive statutory and/or regulatory guides for the stabilizer of this type of offering are in Rule 426 under the Securities Act, requiring disclosure in the prospectus of proposed stabilization, and Rule X-17-A2 of the Securities Exchange Act, requiring periodic reports of stabilizing transactions and notice of the termination of stabilizing. All other statutory and regulatory guides are negative; they include § 9(a)2, the anti-manipulative section, and the anti-fraud provisions of both Acts and the rules promulgated thereunder.[232] The policy of the Commission, in which the securities industry has concurred, has been and continues to be to leave the matter to administrative interpretation since the anti-manipulative section and the disclosure doctrines under the anti-fraud provisions provide effective limits beyond which stabilizing activity may not transcend.[233] This flexibility of regulation is particularly desirable in this field.[234]

The Commission's present interpretation of the scope of permissible stabilizing transactions in fixed-price offerings is that ". . . stabilization for the sole purpose of preventing or retarding a decline . . . does not violate § 9(a)2 or any other section of the . . . Act . . . so long as stabilizing transactions are effected at (or below) the public offering price . . . and that within these restrictions there is no limit under existing statutes and rules as to the amount of securities which may be purchased in the stabilizing process." [235] Therefore, transactions raising the price of the security being offered or creating excessive trading therein clearly are not protected and fall within the ban of the anti-manipulative section.[236] And since the mere act of distributing securities accumulated through a series of transactions raising the price thereof constitutes a strong inference of

229. Letter of Director of Trading and Exchange Division, 11/21/50, p. 1.

230. See note 228 *supra.*

231. S.E.C. 11th Annual Report 21 (1945); 15th Annual Report 45 (1949).

232. Parlin and Everett, *supra* note 227 at 609.

233. Letter, *supra* note 229, p. 1.

234. Parlin and Everett, *supra* note 227 at 612.

235. Notice of Proposal to Regulate Stabilization of Security Prices, Exch. Act Rel. No. 4163 (9/16/48).

236. Opinion of the Director of the Trading and Exchange Division, Exch. Act Rel. Nos. 3505 and 3506 (11/16/43).

manipulation,[236a] *a fortiori* stabilization at that level is also objectionable.[237] Purchases above the offering price pending distribution clearly constitute a series of transactions raising the price sufficient to satisfy § 9(a)2, and transactions of this nature are not excused under the label "trading" if *any* member of the underwriting group is still engaged in distribution, regardless of the position of the person who effects the purchases.[238]

It will be recalled that modern underwriting practice in the United States frequently involves a syndicate over-allotments of about 10% for the purposes of creating buying power to conduct the stabilization.[239] Should the stabilizing purchases be fewer than the short sales, as might very well be the case if the issue is a success, the syndicate manager will have to enter the market and cover the short sales at a higher price than the offering price. However, this must not be done pending the distribution, because the effect of the transaction will be to raise the price for the purposes of inducing purchases by others in contravention of § 9(a)2. The net position of the whole syndicate must be short and stand-off agreements must have been terminated to be outside the category of manipulation.[240] Difficulties of this nature are obviated by the alternative of re-allotting securities purchased through the stabilization program to the dealers who sold them initially, for purposes of resale.[241]

Theoretically anyone may stabilize to facilitate a distribution. In practice usually this activity is restricted to the originating underwriters. Where competitive bidding is required by statute, issuers will occasionally stabilize their outstanding securities prior to the proposed distribution, possibly with a view to securing higher bids.[242] A complaint alleging that an issuer stabilized the price of its outstanding stock at 13½ in anticipation of an additional offering at 13 was held to state a cause of action for misuse of corporate funds, because of the great volume of purchasing necessary to maintain the price at 13½, on the theory that the funds were expended in doing an illegal act, *i.e.*, violating the anti-manipulative provisions of the Exchange Act.[243] The Commission as *amicus curiae* in that case pointed out that bona fide stabilization was legal, but the result is probably posited on a suspicion that the great volume of "stabilizing" purchases needed to peg the price at 13½ indicates that the alleged stabilization really might have *raised* the price to 13½.

Stabilization may be commenced at the fixed public offering price if there is no existing market, this level being the limit at all times, since the

236a. Opinion of General Counsel, Exch. Act Rel. No. 3056 (10/27/41).

237. Parlin and Everett, *supra* note 227 at 619; Matter of Michael J. Meehan, 1 S.E.C. 238 (1935); Matter of Kidder, Peabody & Co., Exch. Act Rel. No. 3673 (4/3/45).

238. Opinion, *op. cit. supra* note 236; Matter of Halsey, Stuart & Co., Exch. Act Rel. No. 4310 (9/23/49).

239. See text following note 196 *supra*.

240. Opinion, *op. cit. supra* note 236; Parlin and Everett, *supra* note 227 at 624.

241. See note 239.

242. Parlin and Everett, *supra* note 227 at 615.

243. Stella v. Kaiser, 82 F. Supp. 301 (S.D.N.Y. 1948).

theory of stabilization is to prevent or retard declines.[244] If there is an existing market it may not be commenced above the first sale price, in the case of a listed security, or above the highest independent bid price, if the security be unlisted.[245] Otherwise the effect of the stabilizing transactions would be to raise the price for the purpose of inducing others to purchase in violation of § 9(a)2.

Raising the stabilizing bid may only be done under the following very limited circumstances.[246] Suppose a fixed offering price at 100, and stabilization is commenced at 100. The volume of purchases needed to prop the market at 100 makes the cost of so doing excessive and the syndicate manager drops the stabilizing bid to 98. The market then independently rises to 99. The stabilizing bid may be raised to 99. Suppose the market independently rises to 101. The stabilizing bid may be raised to 100, but no further. The principles behind these examples are that stabilizing bids may be raised only when the market rises independently, *i.e.*, from the influence of the stabilizing purchases at the lower figure, and reaches the higher level, and in no case may the stabilizing bid be raised above the public offering price. The probable difficulties of proving an independent rise of the market to a level higher than the existing stabilizing bid relegate this problem to academic importance only, it is submitted.

*Statistics as to the Amount and Effect of Stabilization.*—Proper weighing of the economic effects of stabilization requires the consideration of some important statistics. It was found that during 1945-47 approximately 90% of underwriting contracts were on a firm commitment basis calling for fixed public offering prices; the remainder were the so-called "agency" or "best efforts" contracts in which the underwriters are mere selling agents.[247] In 1948-49 the value of all securities floated by firm commitment contracts was $2,758,454,000, as contrasted with only $557,361,000 distributed on a best-efforts basis.[248]

The 1948-49 figures show that of the total value of securities distributed, approximately 65% were debt securities, equally divided between debentures and secured bonds; only 9% were preferred stocks, and the remaining 26% constituted common stocks.[249]

During 1944-45, of the 402 registration statements filed with the Commission, 276, covering 325 offerings, contained a statement of intention to stabilize.[250] However, stabilizing operations were actually conducted to facilitate only 64, or about 20%, of these offerings.[251] During 1948-49, of the 455 registration statements filed, 188, covering 209 offerings, contained notice of an intention to stabilize; but only 66, or 32% of these offerings

244. Parlin and Everett, *supra* note 227 at 617.
245. *Ibid.*
246. Parlin and Everett, *supra* note 227 at 621.
247. S.E.C. Cost of Flotation of Registered Securities 3 (1949).
248. S.E.C., 15th Annual Report, table 1, pt. 2, p. 201 (1949).
249. *Ibid.*
250. S.E.C., 11th Annual Report 21 (1945).
251. *Ibid.*

were actually stabilized.[252] Only 2 of the 66 offerings stabilized were bond issues.

The most damaging practical criticism of stabilization has been that upon the termination of distribution the price drops and consequently the practice allows underwriters to distribute overpriced issues at a profit to themselves. Against this criticism it may be pointed out that the underwriter's spread will be approximately the same even if the price were lower, and therefore the issuer is getting the real bonanza, be there any. The other premise is that issues that have to be stabilized are overpriced. To reach this conclusion it has to be shown that after distribution is completed a more or less permanent drop in price occurs.

In the case of 203 bond issues floated during 1921-31, after eliminating market fluctuations, the Commission found an average drop of ½ point at the termination of distribution; during the second year after issue, the average price was 1½ points below the issue price.[253] A similar study independently taken, of 288 bond issues originated from 1924-32 that were listed on the New York Stock Exchange, showed that 79.3% of the issues, representing 77.5% of the aggregate offering price, "broke" their offering prices within 6 months.[254] The amount of depreciation is revealing:

DEPRECIATION AT END OF 6 MONTHS

| *Points* | *No. of Issues* | *Per Cent* |
|---|---|---|
| 0-½ | 30 | 14.8 |
| ⅝-1 | 32 | 15.7 |
| 1⅛-2 | 31 | 15.3 |
| 2⅛-4 | 45 | 22.1 |
| 4⅛-7 | 35 | 17.2 |
| 7⅛-15 | 20 | 9.9 |
| 15⅛-25 | 10 | 5.0 |

On the other hand, a similar study by the Commission of 19 new bond issues distributed from March 15 to August 31, 1939 showed that 12 of the 19 issues dropped an average of 1.4 points below the offering prices by the third month following commencement of the offering; but on January 1, 1940, the open market price of *every* issue was above the offering price, after adjustment for market trends.[255] And another independent study of 354 bond issues floated from 1927-40 reached the following pertinent conclusions:[256]

252. S.E.C., 15th ANNUAL REPORT 45 (1949).

253. Statement of the Commission, Exch. Act Rel. No. 2446 (3/18/40).

254. Steiner and Lasdon, *The Market Action of New Issues—A Test of Syndicate Price Pegging,* 12 HARV. BUS. REV. 339 (1934).

255. Statement of the Commission, *supra* note 253.

256. Lasdon, *The Market Action of New Issues,* 151 COMMERCIAL AND FINANCIAL CHRONICLE 1774 (1940).

1. 85% of the issues (value basis) could have been liquidated at a profit within 1 year after purchase.
2. The poorest market action was experienced with those issues for which no accurate pricing guides were available.
3. 29 of the 54 issues which broke their offering price and failed to recover within 1 year were patently overpriced, *e.g.*, they fell in a rising bond market, or were priced to yield less than comparable securities.
4. Of the 85% that could have been liquidated at a profit within 1 year, 26.6% did not break their offering price within 6 months.

The Commission unfortunately has never had the personnel nor the funds to compile complete statistics as to the effect of stabilization.[257] The above figures are patently inadequate for they reveal nothing about the behavior of *stocks* stabilized during distribution; most recent stabilization appears to have been undertaken in stock issues. However, it is submitted that the following conclusions may be drawn:

1. As the great preponderance of modern underwriting contracts are of the fixed-price, firm commitment type, the underwriters' arguments concerning the flow of capital into industry must be given weight.
2. The preponderance of recent financing appears to be in debt securities, and the most recent statistics as to these indicate that serious overpricing is not prevalent.
3. However, actual stabilization appears to be concentrated in the distribution of equity securities, as to which no statistics as to market behavior after the completion of distribution are available.

*Proposals for Amendment.*—As part of the general program of amendment of the securities laws initiated in 1941, considerable attention was directed at amending and clarifying § 9(a)6. Some of the testimony indicated a desire to allow departures from the basic principle of stabilization, *i.e.*, that the only permissible transactions are those preventing or retarding a decline in price; *e.g.*, purchasing above the original issue price "for the purpose of meeting dealer demand," while other activities whose legality was argued were subsequently established to be lawful by the Commission's interpretative releases.[258] One of the provisions of the Wadsworth bill provided that no rule or regulation of the Commission promulgated under § 9(a)6 should prohibit transactions effected for the purpose of "establishing a fair and orderly market" providing such transactions were; (a) reasonably necessary for such purpose; (b) not excessive in volume; (c) effected within a reasonable price range; and (d) reported daily to the

257. Letter of Director of Trading and Exchange Div., 11/21/50, p. 2.
258. *Hearings-Amendments*, Twombly, at 1456 *et seq.*

Commission."[259] The purpose of this amendment was to prevent the Commission from nullifying the proposed amendments to § 9(a)2 by its rule-making power under § 9(a)6.[260] That this proposed amendment had the undesirable effect of opening up a loophole for transactions raising or depressing the price of securities to induce action by others was recognized by the Commission, and the bill never became law.[261] In general the securities industry agreed with the Commission that amendment of § 9 was not feasible, and requested only further publicity of administrative interpretations, which has been done.[262]

In 1948 the Commission announced that it was proposing to extend regulation of stabilization and invited comment from the industry regarding the proposed extensions.[263] Questions in which the Commission was "particularly interested" included:

1. Prohibition of stabilization altogether, or of specific types, *e.g.*, by issuers, in advance of offerings, of classes of securities other than that being offered, and overallotments by the syndicate manager.
2. Limitations on the nature and extent of stabilization, *e.g.*, amount of stabilizing purchases; formulae for the dropping of bids, prohibition of increases in the stabilizing bid; and prohibition of trading in the offered securities by persons interested in the offering.
3. Condtioning the right to stabilize upon obligations to "sponsor" the market after distribution, or to prevent any rise in price during distribution.
4. Added disclosure requirements, *e.g.*, the ticker tape.
5. Freer interchange of information among the underwriting and selling syndicates.
6. Prohibition of profiting from price disparities by either purchasers or distributors.

Responses to this request were predominantly in favor of preserving the status quo. The present attitude of the Commission is that its methods of enforcement and investigation have been adequate for the purposes of protecting the public interest without unduly hampering the industry. It is pointed out that the language of § 9(a)2 provides effective limits upon the scope of permissible stabilizing activities, and that for that reason and for reasons of flexibility there has been no necessity for a comprehensive stabilizing rule.[264]

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259. H.R. 4344, § 203(b).

260. *Ibid.*, Statement of Purpose.

261. REPORT-AMENDMENTS.

262. *Ibid.*

263. Notice of Proposal to Regulate Stabilization of Market Prices, Exch. Act Rel. No. 4163 (9/16/48).

264. Letter of Director of Trading and Exchange Division, 11/21/50, p. 1.

It seems very difficult to make an effective argument against the position taken by the Commission, especially in view of the phenomenal concurrence of the industry. It is submitted, however, that because of the intensively practical nature of the problem of stabilization, a comprehensive study of the post-distribution behavior of both stocks and bonds *that have been stabilized* during distribution should be undertaken. This is most important since the most effective argument against stabilization is that it results in price declines after distribution of a more or less enduring nature; the argument that stabilization, being a form of manipulation, is *ipso facto* objectionable, in the language of the Commission, "merely poses the problem but does not answer it." [265] Since there seems no imminent likelihood of American underwriters expanding their capital so that they can become true underwriters, retaining the unsold securities until buyers are found at or near the offering price, as do their British counterparts, the problem of stabilization will be present for a considerable time, as long as the Commission continues to recognize that it has a duty to facilitate the flow of capital into industry, correlative with its duty of protecting investors. In fact these obligations may not only be reconcilable, but also may be coincident to a certain degree.[266]

## CONCLUSION

It is submitted that the Congress and the Commission have been eminently successful in curbing the vicious manipulative practices that prevailed before the enactment of the securities laws, while concurrently keeping sight of the highly practical nature of the problems of "permissible manipulation," *e.g.*, stabilization and special offering plans. The Commission has not allowed itself to be blinded by the free and open concept of a securities market, and has not interfered excessively with devices which cause some slight alterations in that concept. Complaints about "red tape" in this area of securities regulation have been at a minimum.

Future progress in this area should be continuance of the policy of publicly announced administrative interpretation. Manipulation is basically a form of common-law fraud, an offense which neither the courts nor the legislatures have ever found desirable to describe in rigid language.[267] Stabilization, being a practical problem, should not be rigidly regulated because changes in business conditions may invalidate the reason of the regulation. The nature of these problems point irresistibly in the direction of flexible administrative interpretation by an expert commission, which follows the commendable practice of consulting the industry before making extensive changes, and of announcing publicly such interpretations. In one case the procedure was even reversed, the Commission approving an interpretation of its own rules made by an official of the New York Stock Exchange.

265. Statement of the Commission, Exchange Act Rel. No. 2446 (3/18/40).

266. *Ibid.*

267. REPORT-AMENDMENTS.

The only real criticism of Commission administration in this area is the lack of actual knowledge of the price effects of stabilization, for which the Commission's budget is apparently to blame. Because of the concurrence of the industry and the Commission in its present stabilization policy it seems likely that nothing will be done along this line due to lack of interest, barring another 1929, which prospect seems quite remote.

*Christopher Branda, Jr.*